The New York Certified Public Accountant

VOL. XX *November · 1950* No. 11

Society and Editorial Offices: 677 Fifth Avenue, New York 22, N. Y.

BOOK REVIEWS

C.P.A. Coaching Course, Problems and Solutions

By Henry T. Chamberlain. PRENTICE-HALL, INC., New York, N. Y., 1950. Pages: 298 + 397; $4.50.

Undoubtedly the commonest cause of failure to pass the C.P.A. examinations is the lack of proper preparation and training in working under pressure. The Course under review has been designed to overcome this obstacle by providing the candidate with well-organized, timed problems which will enable him to acquire facility in analyzing and interpreting the problems and presenting his solution in a logical manner.

The author presents the student with twenty assignments of three problems each, the suggested time for solution of an assignment running from two and one-half to five hours. In addition, there are twenty-five supplemental problems, each requiring from forty-five to one hundred and twenty minutes for solution. The net result is a suggested one hundred and ten hours of intense practice in the solution of problems which, with the necessary study of basic reference material, should produce a well-prepared candidate.

The selection of the problem material from past examinations is good and its presentation excellent. Instead of concentrating on one subject at a time, the author keeps the student on the alert by his combination of various types of problems, consolidations, cost, fund accounting, etc., in the different sets. The basic idea is to keep each subject alive and to present it under conditions approximating actual examination conditions.

In addition to the problem material, each of the assignments provides five questions on theory and a like number on auditing.

The solutions, which are the work of the author, are presented in a clear, logical manner, illustrative of the form and type of work-papers which should be expected of a candidate for a professional examination.

There is no doubt in the mind of the reviewer that a candidate following the advice of the author and conscientiously applying himself to the completion of the course will bring himself to a degree of "sharpness" which should augur well for his success.

FRANK A. DUNN

Iona College
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Book Reviews

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New Frontiers for the Industrial Accountant

Proceedings of the Thirty-First International Cost Conference (New York; June 19-21, 1950). NATIONAL ASSOCIATION OF COST ACCOUNTANTS, New York, N. Y., 1950. Pages: vi + 138; $2.00 for members, $3.00 for non-members.

The proceedings of the five sessions of the 1950 Conference are recorded in this volume. They include the following papers:

I—Economic Security Plans and the Accountant

What Price Economic Security?
By Percival F. Brundage

Accounting Problems of Economic Security Plans
By Robert C. Tyson

II—Making the Office Functions More Effective

Office Output Can Be Planned, Measured and Controlled
By Paul B. Mulligan

Increasing Office Productivity Through Training
By James W. Quigg

III—Costs To Aid Management in Problems of Alternative Choice

Comparative Costs for Factory Management
By I. Wayne Keller

Distribution Cost Analysis Points the Way to More Profitable Business
By Arthur H. Smith

IV—What We Need in Cost Reports

For General Management
By Roy T. Hurley

For Factory Supervision
By William K. Perry

V—Expanding Opportunities for the Industrial Accountant

The Industrial Accountant's Role in Labor Relations
By Samuel L. H. Burk

Management Opportunities for the Industrial Accountant
By Charles R. Cox

The papers are interesting, informative and authoritative.

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Book Reviews

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Proceedings of the Australian Congress on Accounting (Sydney; November 21-25, 1949)

Sponsoring Institutes: The Institute of Chartered Accountants in Australia, Commonwealth Institute of Accountants, Federal Institute of Accountants, The Association of Accountants of Australia, The Australasian Institute of Cost Accountants. Pages: 294.

This most stimulating volume contains the following technical papers, which were presented at the Congress:

Accounting Standards
By A. A. Fitzgerald

Contemporary Auditing Practice
By F. E. Trigg

The Future Role of the Accountant
By Gilbert D. Shepherd

Influence of Economic Ideas on Accounting
By F. Sewell Bray

New Prospectives in Cost Accounting for Management
By Walter Scott

Widening Responsibilities of Accountants
By T. A. Hiley

The Status of the Accountant in Australia
By N. S. Young

While these papers deal primarily with the practices and procedures existing "down under" in the Australasian lands, this reviewer found that they contain much of great interest and value to American practitioners and students. He strongly recommends a study of the contents by all accounting and auditing study and research groups.

Case Studies in Auditing Procedure—Number 8 (A Steel Fabricating Company; A Small Restaurant)

Sponsored by the Committee on Auditing procedure of the AMERICAN INSTITUTE OF ACCOUNTANTS, New York, N. Y., 1950. Pages: 37. Single copies—$.50; a 10% reduction is made when 10 or more copies are ordered. A special price of $.25 per copy is made to accounting students enrolled in recognized colleges or schools.

This is the eighth of a series of case studies illustrating the actual application of auditing procedures.

THE NEW YORK
CERTIFIED PUBLIC ACCOUNTANT

EMANUEL SAXE, *Managing Editor*

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VOL. XX — *November • 1950* — No. 11

Inductive Reasoning in Accounting—II.

By A. C. LITTLETON, C.P.A.

For readers who may not have seen Part I of the above title*, it seems desirable briefly to state again the theme of this inquiry.

The belief is advanced that accounting conventions, rules, and principles are more closely related in accounting usage than general definitions by dictionaries of the three words would lead one to suspect. If the ideas involved in these three terms can be shown to be closely related in fact, the way would be opened to form our own working concept of an accounting principle. It would be a concept that would join ideas from accounting theory with actions from practice. Presumably this union would tend to give support to the belief that accounting principles are best derived inductively out of accounting actions that are clearly linked with accounting objectives.

The method of idea analysis followed in that article, and to be used here, was to consider groups of accounting ideas sanctioned by long usage, thus having attained the status of conventions. These desired actions were then restated in words that speak a directive or recommendation. Usually, we have called this form of expression an accounting rule. I think this is a limited view. It directs an action or states an expected reaction, but usually fails to indicate clearly the relevant justifying reason. In many situations this could be a very desirable thing to do. Those who issue instructions or directives may not often feel called upon to justify each one to the actors. If directives need to be justified in one's own mind or to his superiors, however, appropriate reasons will have to be found. Others may need to know the supporting reasons—teacher and student, for example. Yet text writers repeatedly neglect to reinforce their statement of the rules of practice with sufficient reiteration of reasons for the actions described or recommended. Students realize that accounting rules are an important practical heritage to be remembered, but many of them fail to see that these rules are rational among themselves. Recognition and use of the latter fact would help foster the development of the student's reasoning powers.

The previous article analysed ten accounting conventions long recognized in common usage. These dealt with

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* *The New York Certified Public Accountant,* August 1950, page 449.

the characteristics of our categories of classification (accounts) and with some of our technology for analysing enterprise transactions and getting the data safely into proper account categories. Now it is proposed to present a discussion of a baker's dozen of examples of accounting action dealing with the preparation of communicative financial statements, the apportionment of income and expense between fiscal periods, and the review and verification of accounting results by auditors. It is believed possible to use ideas in these areas of accounting action as a basis for deriving principles inductively, as in the prior discussion.

Accounting action is not limited to bookkeeping — the analysis of enterprise transactions and the translation of these events into classified entries in a system of accounts. The resulting data need to be summarized and communicated to interested parties who do not have access to the record books themselves. The preparation of financial statements for this purpose is an important accounting action. Perhaps this fact is too broadly stated to be very useful. The nature of financial statements is more clearly reflected in the sub-actions that are compressed in the above generalization.

A highly significant accounting action is made evident in the purposeful arrangement of the data presented in financial statements. The action is significant because it adds to the reader's grasp of the message available in the report. That it is purposeful, planned to serve a recognized need, is indicated by two facts: In the early days of double - entry bookkeeping the data stayed in the ledger accounts; even after the beginning of the twentieth century, the financial statements prepared by some accountants still reflected the characteristic arrangement of a ledger account—that of two parallel columns of figures set in unbroken series and, after inclusion of the balance, leading to two totals of equal amounts. A balance sheet and profit and loss statement thus separated from the ledger for use of people who wanted a compact summary were in essence a copy of two summary accounts in the ledger. Gradually, the judgment of accountants led them to make these summaries of ledger facts more useful. Action (practice) implementing that intention introduced interpretative organizations into the statements—group totals and remainders, contrasting of related items, descriptive terminology, etc.

These are action facts from practice. It is but natural that by precept and example the accountant should transmit the accepted practice to the novice. If need be this instruction could be epitomized into a simply phrased directive, perhaps such as this:

> "When you prepare financial statements organize the data into significant group totals, sub-groups and contrasting remainders, and label all of the items with descriptive names or phrases."

Such an instruction would indeed compress recognized practice into a few words, yet no indication would be given of the justifying reason back of the action. This could easily be done, we need only add another clause to the instruction. This phrasing would suffice:

> "because an interpretative grouping of reported data increases reader understanding."

One may say the reason is so obvious as to be unnecessary. Yet it is obvious only to the initiated. To the layman, for example, it is by no means obvious that accountants have consciously chosen as one of their objectives the aim of using careful arrangements to make financial statements more understandable. Yet the primary purpose of keeping accounts and preparing summary statements has always been to make a business enterprise more understandable.

The other actions in relation to accounting statements to be discussed have a more modern setting.

Financial statements, no matter how simple in form, have always been pre-

pared with a communicative, interpretative intention. Especially under modern conditions some questions have been raised about the traditional arrangements of financial statement data. How adequate has been the execution of the interpretative intention? How revealing are the totals, sub-totals, details?

Auditing was developed to give added assurance of dependability of the data reported. Quite naturally, the auditor felt more responsibilty for verifying the accounts than for the art of arrangement in the statements for effective communication of important details. These matters seemed more the prerogative of management than within the duty of auditors. When, out of the wide ownership of stocks, the conviction grew that the independent auditor had some measure of responsibilty for seeing that the financial statements made an understandable and revealing presentation, the accountant's action broadened to include a consideration of whether the statements gave full disclosure to material items. That line of action is well established and could be epitomized in a brief directive such as this:

> "See that financial statements make a full, clear disclosure of material enterprise facts."

Perhaps this sentence might be called a rule and for some uses that would be satisfactory. Yet it is so important for accounting action to rest constantly and by choice upon reason (thus characterizing accounting as more rational than expedient) that opportunity should be sought to tie the rules, coventions, directives of practice to cogent reasons. If that is done for this directive the following justifying clause might well be attached:

> "because the information needs of a wide variety of people are served by these communications."

The actions of producing an informative arrangement of data and a full disclosure are clearly related to each other. They are also related to two other types of accounting action connected with financial statements. The two items above and the two next to be analysed are therefore stated together at this point. The numbers given each "rule" are merely a continuation of the indentifying series stated in the previous article.

11. In preparing financial statements organize the data into significant group totals, sub-groups and contrasting remainders, and label all items with descriptive names or phrases, because a careful grouping of reported data increases reader understanding.
12. See that financial statements make a full, clear disclosure of material enterprise facts, because the information needs of a wide variety of people are served by these communications.
13. Recognize that enterprise financial statements are necessarily somewhat provisional and inconclusive, because the effect of future events may modify the seeming finality inherent in the figures reported.
14. Ignore fluctuations of price levels as an excuse for altering data already recorded in enterprise accounts, because price changes are usually irrelevant to the objectively determined facts lodged in the accounts until the changes are particularized by actual transactions of the given enterprise.

The first clause of No. 13 is phrased as an instruction. The action thus directed is one of recognizing a fact or condition which experience has shown impinges upon accounting. Accountants habitually react to the fact that one of the inescapable limitations of accounts is this: the figures recorded therein cannot be other than somewhat provisional so long as the data pertain to a going concern. They react for the most part by declining to say or do anything which would indicate that they consider any element of accounting data as an absolute. No item can be an absolute because, as the term "going concern" indicates, finality in a business enterprise comes into the picture only when the concern's assets are wholly realized and applied in liquidation of debts and ownership claims, and because future events, while they cannot alter the quantitative fact of a prior investment or expense incurred, may,

as the second clause in No. 13 suggests, modify the current significance of certain figures. Accountants realize that the relative significance of figures objectively determined today will be interpretatively viewed later, and in the light of subsequent events, by the persons interested. This is to be expected. People habitually view previously determined facts in this way and formulate their own opinions. This they do without asserting or thinking that prior facts are misleading because they do not bear current price tags. The second clause states the reason for the related directive. It aims to give in compact fashion the essence of the ideas outlined above.

Item No. 14 is closely related to No. 13. Some of the reasoning associated with the latter applies to the former as well. It is a customary action in accounting, with few exceptions, to ignore later fluctuations in the price of elements that have previously entered the accounting records. This statement of an accounting convention might be followed by the phrase—"therefore you should do likewise." Taken together these phrases would constitute a directive as effectively as the slightly different form of expression used in the rules previously discussed. Obviously there are many ways of phrasing one's intention. Yet this sentence, as in all of the examples of directives, leaves it to the reader to know or guess or ignore the reason supporting the instruction.

The reason here given stresses "irrelevance." A transaction item is directly and inescapably relevant to an enterprise and its accounts whenever that enterprise is a party to consummating a transaction. A consummated transaction, therefore, is for the parties concerned an irrefutable fact—later legal disputes aside—and the data as a result should be firmly lodged in their respective accounts. Transactions to which a given enterprise is not a party are clearly irrelevant to that concern as facts for recognition in its accounts. A single outside transaction, an average of many outside prices, or a chart of price level change, may be of considerable significance to management *in comparison with* that company's accounting for its direct transactions. Yet, no matter how significant, an outside fact is not an inside fact. And much of the usefulness for management of a knowledge of outside facts is lost if there are no inside facts to weigh against them. In reverse, inside recorded classified facts are more likely to carry their full meaning to an inquiring mind if some significant outside facts are available to be studied concurrently. The two rules here under discussion, and the principles later to be derived from them, attempt to epitomize the idea that better judgment is likely to follow from considering both inside direct and outside indirect facts than from use of either alone or from some mixture of the two that will smother some of the interpretative value of the other.

When well-known accounting actions have been clearly tied to appropriate justifying reasons, the way has been opened for converting that form of expression (a rule) into another (a principle). When this is acceptably done the line of derivation of that principle leads straight back to experience tested actions; hence in origin that principle is an inductive generalization. In the forms of expression used herein for principles the aim is to phrase a desirable accounting end or objective and relate to it a suitable means or method of attaining that end. The two aspects of accounting thus joined are significantly relevant to each other. This is a highly important fact; if a significant relationship does not exist the two ideas should not be joined. But it by no means follows that the relationship of an end and a means to that end are the only kind of tie which could join relevant ideas in a way to show forth a third idea, that of an asserted relationship. The door is therefore open for any one to develop other forms of expression for stating a relationship between accounting ideas which is significant enough to warrant designation as an accounting principle. In the prin-

ciples named below the three dots (. . .) indicate the separating of end and means, or of means and end if they should happen to be reversed.

> *Interpretative Grouping*—Financial statements present organized accounting data in group totals, sub-groups and contrasting remainders . . . as a means of increasing the reader's understanding of enterprise activities.
>
> *Full Disclosure*—Financial statements serve the needs of such a wide variety of people for enterprise information . . . that a duty rests upon those responsible for statement preparation to see that a full, clear disclosure of material facts is made.
>
> *Inconclusiveness*—Unless financial statements are recognized as somewhat provisional and inconclusive . . . the seeming finality of reported dollars figures may obscure the fact that future events can modify the significance of the figures while the figures remain facts in themselves.
>
> *Irrevelant Effects*—Fluctuations in price levels, if used as a basis for changing directly the statistical effects of transactions previously entered in the account . . . usually tend to introduce irrelevant and confusing modifications in the objective measurement of enterprise efforts and accomplishments.

An important area of accounting action is found at the end of each fiscal period. The action then taken is that of making year-end adjustments and transfers. This work of determining appropriate accruals and deferments is a part of the effort to cause financial statements sharply to distinguish neighboring fiscal periods. A simple directive calling for action of this sort might be framed, but it would be so general that it would not be much help in attempting to formulate a useful accounting principle.

A more helpful directive would instruct the accountant to seek clues to the relevance of enterprise efforts to the current fiscal year or to future years, and clues of the relevance of enterprise accomplishments to the current year or to future years.

This will be recognized as a statement of the well-known accounting action of reporting some account data through an income statement and some through a balance sheet. In the present form the intention is to stress *clues, relevance, efforts, accomplishments,* as well as to stress the present and the future represented by the income statement and balance sheet, respectively.

The year-end task can be stated simply as that of appropriately assigning expenses and revenues to the proper fiscal periods. The phrasing indicated is used because it is thought this will help to suggest that year-end adjustments are rationally purposive in connection with the over-all task of making the enterprise understandable. In a word, it may well be that adjustments are more significant in their relation to income determination than to the solvency picture given in the balance sheet.

The reasons for close-cut assignment of revenues, costs, expenses, losses as between periods can be stated in many ways. Reporting by fiscal periods adds informatively to a desired meter-reading of growth or decline, progress or retrogression. It is easier then for the reader to see that change, speed, direction in his enterprise are far more informative facts than total figures can be. The ceaseless flow of enterprise data becomes more understandable when read in successive comparable segments.

A sharp scrutiny of the data marking a flow of the efforts to generate revenue and of the data telling of performance accomplished makes it possible, by familiar adjusting entries, to sharpen the assignment of account dollars applicable to separate periods. Without this sharp scrutiny, superficial clues of relevancy of data to one period or another might be accepted as simpler and easier. The real clues of assignments to the present (via the income statement) are not often found in cash disbursements, for disbursement does not often coincide with effort made. The real clues of assignments to the future (via the balance sheet) are not always found in the power of an asset to discharge debts.

By compressing a justifying reason out of the discussion above and adding

it to the directive as stated, we can formulate the following rule:

15. Seek clues to the relevance of enterprise efforts and of enterprise performance as between the current fiscal year and future years, because only appropriate and sharply defined assignments of expense and revenue as between fiscal periods will produce suitably informative financial statements.

The full statement of an accounting rule is often close to a phrasing suitable for compactly expressing an accounting principle. The above is a case in point.

> *Assignment to Periods*—A suitable assignment of expenses and revenues to fiscal periods . . . rests upon the relevance of effort and performance to the present or to the future.

Here the end is stated first, the means to that end last. If the means are not suitable to that end this is not a statement of principle, for no significant relationship would have been expressed. If certain assignments of expense do not represent efforts or if the efforts were not relevant to the current period, that situation would fall outside this principle and would not lead to accounting action affecting the current period.

The principle of assignment to periods may seem phrased in a way that merely constitutes a statement of fact. But this is true only in the sense that in practice we do make assignments to periods, being guided by relevancy toward one kind or another kind of assignment. It would still be a statement of fact to say: Accountants habitually make relevant assignments of expense and revenue to periods. Yet in that form the relation of action and objective is not made clear; a statement of principle would aim to express just such relationship.

When we turn to a consideration of other and more specific actions involved in assignments to periods we find a need to look more closely at the concept of relevancy. It may be a limited view to think that some clue or other will always automatically tell whether an accounting item is relevant to this year or to future years. It does not help to say the item belongs in the current period or it is unmistakably and wholly current expense. Familiar situations, whose accounting resolution we have come to know intimately, are treated appropriately without a full conscious analysis of the factors which justify the assignment given them. However, we need to be able to dig behind any proposed treatment, if occasion requires, and expose to other people's view the reasons which make our treatment an acceptable one. It is at this point that carefully phrased accounting principles may be of most help since, by design, these forms of expression make considerable use of accounting ends, aims, objectives—the accounting reasons beneath accounting actions.

We come then to the idea that it is not only by relevance to the same fiscal period that brings certain amounts of expense and revenue into the same income statement. Clues to the most informative matching of cost, expense, loss and revenue should also be sought in aspects of mutual relevance between them. This is to say, it is inherent in business that certain costs, expenses, losses shall be recognizably related to specific items of revenue.

By means of cost accounting, for example, a considerable accumulation of costs and expenses is identified with a certain production order; this accumulation follows the items produced into the inventory records, thence into the cost of sales account. Here the clue to matching is not deduced merely from existence of items within a fiscal period. Rather, the matching of specific cost and specific revenue has been contemplated from the time of organizing the cost finding procedure. That parcel of costs and that amount of sales income "belong together." We can say that because they are but different facets of an identifiable unit, yet cannot say the same for all matchable items. The ideal matching of expense and income would be one in which all items associated together in one income statement would be as causally related

as these job costs are to the sales income from that job. The ideal is not always attainable, yet it can still be of service for an ideal can serve by leading us in a desirable direction.

The idea of mutual relevance can be stated in this way: Costs, expenses, losses should be matched as far as possible against their related revenues; revenues should be matched as far as possible with their related costs, expenses, and losses. The statement is not much help in situations where causal connections are not clearly evident. Such connections can sometimes be detected however by close scrutiny or by finding reasonable and rational bases for apportionment. Cost accounting has made outstanding contributions by this method. Perhaps the same techniques could be applied in other areas. Insofar as this can be done, it will result in fewer items matched in an income statement merely by the accidental or expedient fact of appearing together within a certain time period.

Accounting for revenue illustrates the need for bases of assigning to periods other than mutual relevance with some other identifiable item.

Beneath every revenue transaction is an enterprise action of rendering a service asked or of supplying goods chosen by a customer. This action marks performance by the enterprise. Accounting action is one of recognizing the account features of enterprise performance, i.e., (1) the time of performance objectively places the revenue transaction in time, thereby fixing its relevance to a given fiscal period; (2) the dollars amount as agreed on by the parties objectively determines the quantitative aspect of the revenue transaction. The accounting action may therefore be said to yield the following rule, consisting as usual of a directive and a justifying reason for the action.

16. Obtain objective evidence of services rendered and goods sold by the enterprise because an unobjective basis of assigning revenue to the present, or of postponing the recognition of it, will produce distorted periodic reports.

A well established convention of accounting can be expressed in this simple statement: Profit is realized when sale is made. This may be a compressed bit of truth; but it were better turned around: No profit can be realized unless a sale is made. Adam Smith said something to the effect that profit appears only when goods change masters. It is the same idea. Yet the accounting fact of profit or no profit cannot appear with the revenue transaction. The latter affords a means of preparing to determine, by deductive costs, etc. whether the price received includes anything for profit.

Another accounting convention may say: Revenue is recognizable when a sale has been made to a solvent debtor. Here we seem to be looking to a legal fact as the clue to revenue recognition. However, it may be well to note that the legal fact (a valid claim against a debtor) is itself dependent upon a prior economic fact (a service asked and performed). Thus, the same solid basis exists for accounting recognition as for legal recognition. It would seem best to direct accounting thought to the basicly objective fact of economic performance, and to consider the resulting legal claim against a debtor as corroboration only.

It seems therefore that these two accounting conventions do not lead very directly toward an accounting principle. Nothing is said in them that clearly ties a directive into its justifying reason or unites a desirable accounting end and suitable means to that end. The reason advanced (to avoid distorted periodic reports) is one that justifies many different accounting actions. It also constitutes an important general aim of accounting since any distortion of figures as between fiscal periods produces some degree of statistical mis-classification and this is an accounting falsity as well as a statistical falsity.

It will be evident that revenue is more often the leading clue to the assignment of applicable costs, expenses, and losses than the latter are clues to the recognition of revenue. It will also

be noted in the following statement of principle that recognition, not realization, is the key word of the objective.

> *Revenue Recognition*—Objective evidence of services performed and of benefits received in return . . . afford the only acceptable basis for periodically assigning revenue to the present or of alternatively deferring recognition into the future.

Items 15 and 16 have dealt with certain aspects of assignments between periods or, in other words, with periodic income determination. While the principles thus formulated are pointed toward the income statement, it will be clear that they also give collateral direction to the determination of many items for the balance sheet. This points again to one of the most characteristic features of double entry bookkeeping—the interlocking of real and nominal accounts.

Most of the items discussed next deal with the deductions from revenue that receive recognition in the income statement. Following these a few principles oriented to auditing will be presented.

17. Periodically scrutinize the stream of enterprise expenditures for evidence of accruals, because it is important to dependable reporting of net income that all costs, expenses, and losses justifiably associated with current revenue shall be thus associated in the income statement.
18. Exclude continuing usable long-lived assets from treatment as current revenue debits, because such assets are expected to make their contribution in future periods.

The directive portions in these two rules speak of two familiar accounting actions, those of accruing and of deferring. No additional argument needs to be made here in this connection. The reasons for the actions are in part considered above in connection with the discussion of financial statements and of assignment to periods. In part the essence is found in such phrases in No. 17 and 18 as "dependable reporting", "justifiably associated", "continuing usable assets", "contribution in future periods." These tell again of the key thought: measure and classify enterprise efforts and enterprise performance. The transformed action-based rules when made into principles to express a significant relationship between ends and means, also tell of this key thought.

> *Accrued Charges*—The current efforts of an enterprise are placed under periodic scrutiny . . . in order to assure the inclusion as current revenue debits of all costs, expenses and losses justifiably connected by objective evidence with current revenue credits.

> *Deferred Charges*—The stream of enterprise expenditures is placed under periodic scrutiny . . . in order to screen out of current revenue debits those long-lived elements whose capacity for making later contributions show they lack justifiable relation in full amount to current revenue credits.

The key phrases in the objective section of these two principles are similar, "justifiably connected" and "justifiable relation." When and if there is disagreement as to deferments or accruals the debate centers in one way or another upon the meaning of these phrases. Thus it will be evident that the formulation of principles in compact phraseology does not render debate unnecessary. Why is this and not that justifiable? What is the best statement of a given desirable objective? How can it be determined that such and such is the most suitable means to the stated end? Such questions will offer ample opportunity for continued discussion of accounting ideas and practices. Perhaps the lines of profitable debate may be the more clearly marked because of attempts to formulate accounting principles in a way that stresses objectives tied down to accounting actions.

Rule 18 and the principle of deferred charges are formulated to generalize upon the central idea involved in deferred charges to operations, that is, the postponement of charges to expense until the effort that justifies an expense entry has been made. Expense inventories and various prepayments for expense services are the usual scene of "deferred charges adjustments." But fixed assets, since they usually are owned with productive intentions, also have the characteristics of deferred

charges, of investments waiting their day to serve. In other words, this rule and the principle are part of the idea of reporting dollars of invested cost as being an expense only when a contributing effort has been made. Before that time the invested cost represents effort potential.

As a result of this principle several collateral truths are evident. To charge a long-lived asset to expense at time of acquisition cannot faithfully express effort made, for it is clear that, unusual circumstances excepted, much of the original service potential stands to become effort in the future. To charge a long-lived asset to expense only when it is retired from service is to neglect to report an obvious truth, that the asset was contributing effort throughout its past life. To charge as expense the replacement price of an equivalent asset is to inflate the measurement of expired effort potential. The principle therefore pointedly directs attention toward a preference for expense accounts in terms of historical cost because that figure best reflects effort potential now converted into effort made.

The next two formulations probably are more controversial than any of those thus far analyzed. Whereas most accounting principles will be but a special form of expression for familiar accounting ideas and practices, these two may suggest one approach to further consideration of possible extensions of the accounting art of making periodic assignments which constitute such an important part of accrual accounting.

Accounting action sometimes includes the reporting of significant facts as soon as they become known even though they are more directly related to a previous period than to the current one. Accounting action also gives some support or acceptance to advance provisions related to enterprise events before the events themselves have occurred. When these actions are phrased as directives with an attached justifying reason the following tentative statements of two more accounting rules result.

19. Find ways of clearly reporting lately ascertained facts in a manner that will disclose how these facts, if known earlier, would have made prior revenue debits different, because periodic revenue debits are a connected series of statistical data which sometimes cannot initially be estimated with full correctness.
20. Upon proper occasion make provision for all reasonably measurable costs, expenses, losses without waiting for full validation, because the modern income statement, in order to present the most informative dependable debits may at times need to be carried farther than is possible if their sole basis is furnished by completed transactions related to expenditures made and liabilities incurred.

If later ascertained facts relate to the expense accounts (efforts) of a prior period, bookkeeping procedure prevents later entries from bringing these facts above the red line that has closed the account. The result is two-fold. Corrective adjustments can be made in real accounts but not in nominal accounts. As a substitute the nominal account element is brought into surplus. Such an item resting in surplus may not adequately reveal the relevance of the item to previously reported expense. The effect therefore is to modify by an omission the power of comparative income statements to reveal "a connected series of statistical data."

It seems a little unreasonable for the incidental matter of red lines ruled beneath an expense account to produce in the mind of the reader of financial statements the impression that the expense figures for last year are final, conclusive and beyond correction. If management can blink an accruing expense today and later clear the real account by making a charge to surplus, the relevance of that expense item to the previously calculated periodic net income may not be perceived by the reader. This situation may indicate a spot in accounting where desirable ends are visible before suitable means for achieving those ends have been given acceptance in practice.

In No. 20 the important phrase in the directive is "without waiting for

full validation." Two examples will illustrate this type of accounting action. It is customary to record our check as being a deduction from the balance at the time of issue rather than at the time the check clears our bank. The latter is the legal fact of decrease to the balance. We do not wait for that validation of a disbursement because experience with a multitude of checks has shown that such validation soon follows in all but a few exceptions. Allowance for loss from uncollectible receivables is a standard financial action approvingly accepted by auditors. Yet full validating of the expense debit does not appear until a specific customer's debt is known by objective evidence to be uncollectible. We do not wait for that event because experience has given business men a quasi-statistical basis for an advanced determination of facts whose later validation we know will presently be fully established by objective events.

When and if this later validation proves to be materially different from the advance estimate, our method of or ability to estimate suitably will be called in question. If the failure to match estimate and later reality grows, then estimating must be abandoned as unsatisfactory reporting. On the other hand, if in other accounting situations some experimenting shows that realistic advance estimates can be made of facts which will be validated presently by objective events, there would seem to be reasonable grounds for applying the bad-debts technique to making other "provisions" that deserved to be treated currently as expense facts. It is doubtful however that this treatment should be extended as far as creating reserves for mere contingencies by debits reported as current expense.

There seems some justification in the above discussion for framing these two tentative principles.

> *Related Charges* — Statistically correct reporting of revenue debits for a connected series of fiscal periods . . . requires later corrections to be clearly reported as such when later ascertained facts show that expense or loss would have been charged against revenue if the facts has been known earlier.
>
> *Estimated Charges*—Provision for certain costs, expenses, and expected losses is an essential part of the current determination of net income . . . even though they have not been ascertained by actual expenditure, if they can be reasonably anticipated and convincingly measured by other means.

It is not necessary to deal extensively here with auditing principles that can be derived inductively out of auditing actions. Three examples will suffice to suggest possibilities.

It is a well known part of audit action to make tests of transaction data for evidence of error, etc. Business men retain auditors partly for the reason that outside scrutiny will increase the credibility of financial statements. These facts about auditing may be rephrased into a directive and its supporting reason.

21. Make suitable tests of transaction data for evidence in accounts of possible error, misrepresentation, distortion, fraud, because the use of planned scrutiny can often uncover error and also give added assurance as to the credibility of the data reported in financial statements.

The audit actions beneath the directives in the next two rules will not need elaboration. Auditors do examine an accounting system critically; they do secure corroboration of transaction results.

22. Make a critical examination of the accounting system and of the results produced by its operational processes, because examinations by qualified persons increase the dependability of financial statement disclosures and the reliability of interpretations readers make from the statements.
23. Secure suitable corroboration of transactions results and appraise enterprise accounting policies, because it is the auditor's duty to substantiate the representations made by management in the enterprise accounts and financial statements.

The instructions become, in the restatement below, the means, and the reasons become the ends; in this form the phrasing indicates the significant

relationship which links two ideas and makes the sentences speak accounting principles.

> *Statistical Credibility*—Since transaction data are subject to misinterpretation or distortion and erroneous or fraudulent treatment in the accounts, the statistical credibility of the figures reported in the financial statements may be in doubt . . . unless the accounting processes and the resulting data have been tested by audit.
>
> *Critical Review*—A critical examination by qualified persons of the structural mechanisms of an accounting system and of the results produced by its operational processes . . . supports (or questions) the dependability of statement disclosures and the reliability of interpretations made from the statements.
>
> *Corroborative Evidence* — The external auditors seek to substantiate the representations made by management in the accounts and statements of the enterprise . . . by finding various kinds of corroborative evidence and by appraisal of enterprise accounting policies.

Some of the motives of an auditor are indicated here: increase statistical credibility; produce dependable disclosures; substantiate the representations of management. And some of the methods: test processes and data; examine critically; find evidence, appraise policies. Other objectives also supply audit motivation. And the closer we come to the details of audit procedures, the less broad and general are the motives involved. But it will be noted that close-by motives chain upward to higher level motives. Altogether motives, ends, objectives should form a rational pattern of controlling intentions.

Much the same thought applies to methods. Broad methodology needs to be broken down into sub-elements of action for assignment to different persons. The elements involved in any one audit engagement will form their own pattern within the framework of the kind of enterprise, the nature of the contracted engagement, and the skill of the builder of the audit program. But this pattern of specific procedures should be known to take into consideration the limitations and capacities of audit techniques, that is, the broad aspects of methodology.

Of induction in accountancy this may be said: Rules should be more than directives to action; actions also need justifications. Objectives should be knowable; they should be attainable by existing means. It should be possible always as needed to associate ends and aims with ways and means.

Perhaps agreement can be had that some such pattern as this exists between accounting ideas and actions. If so, the way is opened for consideration of other important matters. Are there other objectives? Are the stated ends and aims desirable? Is the phrasing of objectives clear and convincing? Are the means suited to the attached ends? Among various possible means, why is one better under given circumstances than others? Is the phrasing of ways and means fully descriptive of the experience and judgment of practitioners?

The Interim Report as a Basis for Extending Credit

By SIDNEY LICHTER, C.P.A.

DURING the past two or three years, we have witnessed drastic changes in business conditions—both generally and specifically. We have seen sales virtually drop to nothing overnight and a backlog of orders disappear even faster.

More recently we have witnessed a sudden rush to buy merchandise. A number of companies have invested a great proportion if not all of their working capital in inventory. Some have overextended themselves.

Large corporations with substantial capital and reserves can most often withstand such temporary changes and suffer losses without having their credit ratings impaired. But, for the smaller or medium-sized company, under today's economic conditions, a few months' operations may so adversely affect them as to give them a lower credit rating or even make them a bad credit risk.

Thus, it is quite possible for a year-end statement to be inadequate and even misleading as a basis for credit extension a few months subsequent to the date of the statement. Up-to-date statements are therefore a vital necessity to those interested in the financial condition of a company.

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This paper was presented by him at a technical meeting of the Society conducted at the Engineering Societies Building on May 16, 1950, under the auspices of the Committee on Monthly Audits.

During the year, this need is fulfilled by the monthly or interim report. These reports may also give warning of any new trend the business is taking. As a result, the monthly or interim statement is becoming more important and more in demand. It is regrettable, however, that due to the fact that the interim or monthly statement is usually uncertified, there is a tendency among accountants to give it less attention and scrutiny than it deserves. They overlook the fact that these statements are a barometer of the company's financial condition, constantly referred to by credit men in determining whether credit limits should be raised or lowered during the year.

To the credit man, an interim statement based on an audit means an independent review of the company's operations by a competent person outside the business. It is this independence which gives the grantor of credit the assurance that the financial condition of the business as set forth in the statement is correct, subject, of course, to any qualifications that may be indicated. On the non-certified interim report, in particular, the credit man must rely on the ability and integrity of the accountant to delineate carefully the work done by him, even though no opinion is expressed.

Every statement, year-end or interim, should state the facts with accuracy and completeness, each within the limitations carefully noted thereon. For this reason, all monthly or interim reports should have a transmittal letter, setting forth the scope of the audit. Without it, the reader has no comprehension as to the weight he can attach to the figures—or worse still, he might attach the wrong emphasis thereto. No financial statement should be released

by an accountant unless he feels that, to the best of his knowledge, it correctly sets forth the financial status of the company disregarding any technical protection he may have through the wording of the transmittal letter.

I have often wondered what the credit man thinks when he receives a statement on the letterhead of a company, or an accountant, with no indication of the scope of the audit—no signature—nothing but the balance sheet. I know I am always puzzled as to how accurate the statement may be, why the signature is absent, and what the reticence of the management or accountant may conceal.

A statement prepared on the stationery of an accountant and signed by him with the notation that it is a transcript of the books of account is almost as bad. Inasmuch as it is a mere transcript, the credit man cannot depend on the accountant for the accuracy of the figures. He can only rely on the character and integrity of the management. The accountant is pushed into the background. I believe that the accountant who issues a statement of this type does harm to his professional standing and reputation.

To the credit man, the current assets, current liabilities and earnings of the company are the most important parts of the statement. These items indicate to him whether the debtor or would-be debtor will be able to meet his obligations. It is, therefore, of particular importance that these accounts be properly labeled and classified.

Credit men tell the following story of improper classification. A balance sheet set forth Notes Receivable as a current asset which were due within a year—and so they were. However, these notes had been received years back and were always being renewed. Obviously, to the credit men, they really were not current. Technically, it may have been correct to label the notes as current assets since they were payable within the year. Nevertheless, if a report is being issued for credit purposes, it is misleading to have them in the current assets section. At the very least, the balance sheet should contain some footnote or reference that would put the reader on notice.

Another illustration of improper presentation concerns the labelling of the Accounts Payable on the balance sheet of a doubtful credit risk. As presented, the Accounts Payable were stated at $35,000. Subsequent investigation disclosed that the Accounts Payable were $50,000 offset by debit balances in the schedule in the amount of $15,000. A major portion of the debit balances were of doubtful value. In any event, it was misleading to the reader to have the Accounts Payable stated at $35,000. A proper audit would have disclosed this situation and proper classification would have put the debit balance in the Assets section.

Since the current assets and liabilities are most important to the credit grantor, unpaid expenses and taxes, including income taxes, should be accrued; depreciation and amortization charges should be set up; bad debts should be written off, etc. These adjustments often amount to many thousands of dollars, and might conceivably make the difference in the granting or non-granting of credit, or in the amount of credit extended.

It may be argued that doing all these things takes time. True. The very fact that you are asked to prepare a statement or do an audit means you will have to spend time. It really takes very little additional time to do the extra (if they are extra) things that make for a complete and accurate report. And it is a well-known fact that credit grantors favor those who are known to do a proper audit and present a correct report. If an accountant wants to enjoy a favorable reputation with the credit grantors and in the profession, he will have to do these "extra things."

There are a great many other points that could be covered with regard to the proper presentation of interim statements for credit purposes. However, time will not allow me to do this.

(Continued on page 657)

A Banker Reviews Certain Phases of the Accountant's Responsibilities

By CARL H. MAAR, C.P.A.

WHEN your Program Committee suggested this topic they also requested that I confine it to two phases of responsibility: the subject of abnormal outstanding commitments and the responsibility for disclosure of events after the balance sheet date. I am not at all sure that I can add much to what has already been said and written on both of these subjects, but at least let us bring these two important parts of the accountant's responsibility out into the open and look at them. I am willing to concede at the start that some of this material is controversial and, therefore, I hope that we shall have a lively discussion period.

Many years ago when I started out on my first auditing assignment as a traveling auditor for the General Electric Company, my superior who was then the Comptroller of GE, offered me a definition of accounting which I can never forget. He said that "accounting is the 'science' of the difference of opinion." If anything, that definition has more meaning today than it had 28 years ago. As we all recognize, accounting is not an exact science and in the final analysis when the accountant puts his signature on a financial statement, he is reporting that in his *opinion* the statement is a fair one subject to whatever reservations he may make. One definition of the word *opinion* is "a settled judgment formed after deliberation." I would like at the outset here to emphasize the importance of this word *opinion*, particularly from the viewpoint of the banker. Rightly or wrongly, those of us in the banking profession, who are charged with administering loans have come to rely very heavily upon financial statements prepared by Certified Public Accountants. I think sometimes that we rely more than we are entitled to. Then, every once in a while, we run into a loan situation that turns "sour" and human nature being what it is, we take a backward look and try to find some excuse for having made the loan in the first place. Once in a while we find that we based our judgment on a financial statement which did not disclose everything that might have been disclosed at the time, and then we are prone to censure the accountant instead of re-examining our own investigation processes. I have seen this happen many times and it is unfortunate, but it does emphasize the importance of the two particular responsibilities that I will talk about.

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This paper was presented by Mr. Maar at a recent meeting of the Syracuse Chapter of the Society.

Abnormal Outstanding Commitments

Many of you have probably heard of the Robert Morris Associates, a national organization whose members are lending officers in commercial banks throughout the country. The associates

have a standing committee which works in cooperation with a committee of the New York State Society of Certified Public Accountants, in an endeavor to promote the mutual interest of the two groups. The question of disclosures of unusual and abnormal commitments has been discussed in joint meetings of the two committees and your Society has gone on record[1] as stating that commitments are an important supplement to balance sheets where they are unusual in *amount, time, price,* or *circumstances.* It is agreed that where commitments are not affected by any of these factors but are merely commitments in the normal course of business, no supplementary remarks need be made, but that wherever there is occasion to comment, the comment should be sufficiently descriptive to permit evaluation of the unusual factor. Purchase commitments are generally thought of in connection with inventories, but might also relate to physical property, equipment, real estate, and contracts involving future performance. One example of the importance of disclosing abnormal purchase commitments should suffice. In the period immediately following World War II, when consumer goods were in short supply and demand was great, there were numerous instances in the manufacturing, distributing, and retail fields where duplicate and sometimes triplicate and quadruplicate orders were placed for the same merchandise. Then, as the pipelines filled up, it sometimes happened that an over-supply developed in the hands of the purchaser almost overnight. When this over-supply was accompanied by a softening in price, a real problem resulted. We, who extend credit, must always keep in mind that business is dynamic and not static and certainly mention of unusual commitments in the accountant's report puts the credit grantor on notice. If he neglects to make further investigation, the accountant has performed his obligation.

Disclosure of Post-Balance Sheet Events

The second part of our discussion relates to the accountant's responsibility for disclosure of events happening after the balance sheet date. Most of you, undoubtedly, have read the excellent article in the April issue of the Journal of Accountancy by Mr. E. B. Wilcox, in which he discusses this entire problem in a very thorough and understanding manner. As in the case of purchase commitments, much reliance is placed on the judgment of the accountant as to what events are of sufficient importance to warrant a comment as a footnote to the financial statement. Certainly, we cannot expect the accountant to be a clairvoyant, nor can we expect him to extend the range of his comment beyond the actual date on which his report is prepared. In his article Mr. Wilcox calls attention to the fact that the Securities Exchange Act of 1933 contained a provision that the standard of reasonableness shall be "that required of a prudent man in the management of his own property." He then quotes the description of a reasonable or prudent man as given by an English judge some years ago, the conclusion of which is as follows: "devoid of any human weakness with not one single saving vice, without prejudice, procrastination, ill nature, avarice and absence of mind, as careful for his own safety as he is for that of others, this excellent but odious character stands like a monument in our courts of justice, vainly appealing to his fellow citizens to order their lives after his own example." It strikes me that many of our Trust Officers in banks should read this definition before cheering too loudly about the new "prudent man" provision in the New York State Trust Laws.

[1] Answers to questions presented by the New York Chapter of Robert Morris Associates by Society's Committee on Cooperation with Bankers at a joint meeting held on February 17, 1942.

While a good portion of Mr. Wilcox's article is devoted to a consideration of the accountant's responsibility with respect to registration statements filed with the SEC, I believe that the same observations pertain to the annual report although in the latter case the accountant's job is much simpler because there is not apt to be the time lag that frequently arises when accountant's reports are used in a registration statement.

The accountant's responsibility for disclosures of this kind has been the subject of much discussion in various committees of the American Institute of Accountants. For instance, Accounting Research Bulletin #38 issued in October, 1949, states clearly the type of disclosures which should be made in the case of long-term leases. Then Statement #1 of the Committee on Auditing Procedure of the Institute sets forth that the independent Certified Public Accountant, by reason of his training and experience, has acquired certain abilities as a result of which his "opinion provides reasonable assurance that a fair and adequate presentation of pertinent information has been made in the financial statements." Note again, the emphasis on the word "opinion" which we defined earlier.

Now let us mention a few of the most usual events which may occur subsequent to the date of the balance sheet but prior to its preparation and presentation. First, there is the matter of evaluating the collectibility of accounts receivable. As I recall auditing procedure, one of the yardsticks is to age the accounts and another one is to check payments received after the balance sheet date. Beyond that, unusually large items, that is, large in relation to the total, are subject to further investigation by referring to credit files, etc. Certainly if one of these important debtors filed a petition in bankruptcy during this intervening period that fact would influence the accountant's judgment as to the collectibility of the account. Along this same line, when auditing the books of a concern whose sales are limited to few customers in large individual amounts, the bankruptcy of one of these customers might seriously affect future sales possibilities.

In the field of inventories, the accountant should be alert to spot any sharp price declines occurring after statement date, particularly if inventories are abnormally high. In this connection I recall going to Chicago in 1921 to make an audit of an important manufacturing concern located on the extreme north side of that city. As I was crossing the Chicago, Milwaukee and St. Paul Railroad tracks to reach the plant on the first morning, I noticed six carloads of steel on the company's siding. I presented my credentials to the president of the company and while talking to him mentioned those cars of steel which we could see from his office window. He immediately became alarmed and began an investigation which subsequently disclosed the fact that the purchasing agent, who had given the orders for this steel, had not been at his desk for four days and that he was in collusion with the salesman for the steel company. Not only did this concern have a full year's supply of steel on its hands but, more unfortunately, the price of steel had slumped some 30% between the date of the order and the date of shipment and a sizable inventory loss resulted. Surely this type of event should always be mentioned in the accountant's report.

Sometimes marketable securities are an important asset item and their values may change rapidly. Market prices are subject to rather severe fluctuations and if this item is of sufficient relative importance any adverse change should be noted.

The matter of fixed assets requires careful investigation on the part of the accountant. Perhaps a substantial portion of the plant has been destroyed by fire thus resulting in a loss of the asset, but more important than that is a potential loss of production which if continued may even threaten the company's existence. Or management may have contracted for a large expenditure for

plant expansion, or for new equipment, the result of which would be a serious depletion of working capital.

There are many other situations for which the accountant must be alert, such as unwarranted retirement of company stock, purchase of a subsidiary, or an affiliated company, loans to officers and directors, etc. One of the best sources of information about events occurring subsequent to the balance sheet date is the minute book which records the actions of the Board of Directors. I have always assumed that the reading of the minute book was standard auditing procedure, but in a recent instance the accountant admitted that this was not done.

* * * * *

I have merely tried to point out a few of the obvious events to emphasize the broad responsibility that accountants must assume. As I mentioned in my opening remarks, we bankers do rely very heavily upon the accountant's reports and many times presume a responsibility which we should not take for granted. I am happy to tell you that in the vast majority of cases, the accounting profession has fulfilled this responsibility, but you do have an important duty to keep wide awake and to realize always that the reports which you prepare are frequently used as a basis for credit and are an important tool to the banker in forming his judgment.

The Interim Report as a Basis for Extending Credit

(Continued from page 653)

The main theme I have tried to emphasize is that because of unsettled business conditions that exist today, the monthly or interim report has become an important document. For the medium-sized or small company, the year-end statement is no longer sufficient.

Correct decisions are founded on sound information and upon facts as they exist at the time of the decision, and not some months earlier. It is the monthly or interim statement that gives this current information. It must be prepared and presented so as to give as complete and accurate a picture of financial conditions as is possible.

Church Accounting

By Leopold Roeder, C.P.A.

A church may be defined, for the present purpose, as a body of people organized in a community for united worship at a fixed meeting place.

Churches of different sects and denominations vary in the form of organization, depending upon the extent to which they are under control or discipline of some higher body, such as a presbytery, synod, or episcopacy. This relationship may have some influence upon their financial affairs. However, the individual local churches usually have the problems, in common, of raising revenue to meet the expenses of operation and rendering an accounting of the monies received.

In the discussion of these problems it will serve to consider as a typical case an individual church organized and acting as an independent entity. Its by-laws vest authority and responsibility for all temporal matters in a Board of Trustees, and for spiritual matters in a Board of Deacons.

The principle source of income is in the envelope collections, representing contributions, pledged and unpledged, by the members of the congregation. In addition, there are plate collections at each regular service and special offerings solicited in advance of the important church days, such as Easter Sunday, Thanksgiving Day, and Christmas. Although the facilities of the church are available to other organizations engaged in community activities not inconsistent with church policy, no rental is charged for such use, but voluntary contributions toward maintenance are received occasionally from these sources.

Toward the close of each year a campaign for pledges for the new year is organized. An appeal is sent out in the form of a letter to each member of the congregation, setting forth the estimated total financial requirements, and enclosing a pledge card to be filled in and returned by a designated date. The pledge card provides for insertion of the amount to be subscribed (weekly, monthly, or annually) to each of two funds—the Current Expense Fund and the Benevolence Fund.

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The Current Expense Fund provides for the payment of salaries; maintenance, repair, and replacement of physical property; and services and supplies required in carrying out the church program. This fund is under the control of the Board of Trustees.

The Benevolence Fund, administered by the Board of Deacons, provides for the support of missions, both foreign and domestic, charitable institutions operating under denominational patronage, other denominational and inter-church activities, and local charitable needs.

Each member of the congregation, whether or not he has returned a signed pledge card, is furnished with a set of fifty-two numbered envelopes bearing dates of consecutive Sundays, in which to place his contributions. An account is maintained in his name, identified also by his envelope number, and recording the totals of his pledges, if any, for the year, indicating separately the amounts pledged for Current Expenses and for Benevolence. As the envelopes, included in each Sunday's collections, are opened, the envelope number and the amount enclosed therein are listed, and the total of the listing proved to the total of the twice counted cash. The list of envelope numbers and contents serves as a medium for posting to the individual accounts.

Weekly offering envelopes are obtainable from specialty manufacturers in various forms. Some provide two pockets in which to insert contributions for separate purposes, such as Current

Expenses and Benevolence. It is also possible to obtain separate sets of envelopes for several purposes. The plan here discussed provides a single pocket envelope to accommodate contributions to two funds.

The Treasurer of the Board of Trustees, who is responsible for the weekly deposit of collections, is obligated to transfer to the Treasurer of the Benevolence Fund the amount of the Benevolence contributions included therein. With the concurrence of the Board of Trustees and the Board of Deacons, there is transferred each week from the amount collected under pledges a fixed percentage representing the ratio of total Benevolence pledges to the total of both Current Expense and Benevolence pledges for the year.

At the close of each quarter the total received to date from each pledged contributor is divided in the proportion of his individual pledges to the two funds and the division is recorded on his account card. The grand total of Benevolence contributions thus computed is compared with the total of the transfers previously made to the Treasurer of the Benevolence Fund and the difference is added to or deducted from the amount of the next regular weekly transfer.

Following is a classification of the usual expenses for which disbursements are made through the Current Expense Fund:

Account	*Expense*
Salaries	Salaries of Minister, Assistant Minister, Church Secretary, and Custodian
Music	Compensation of organist and soloists, organ maintenance, and sheet music
Repairs and Replacements	Labor and material for repairs and improvements to buildings and equipment; purchases of equipment
Heat, Light, and Water	Fuel oil, fuel gas, electric current, and water
Insurance	Fire, liability, burglary, and fidelity bond premiums
Printing and Advertising	Church calendar, news letter, newspaper announcements, etc.
Stationery and Office Supplies	As indicated
Postage and Telephone	As indicated
Maintenance Supplies	Cleaning materials and supplies and minor equipment for maintenance
Taxes	Real estate taxes on parsonage
Pensions	Payments to denominational ministers' pension fund
Sundries	All other expenses

The accounts are maintained on a cash basis. Since the pledges are voluntary and are subject to cancellation, no attempt is made to record them as receivables; nor is any liability set up for unpaid bills, as it is the practice to make prompt payment for all expenses or commitments incurred. The principal books of account, therefore, consist of the cash receipts and cash disbursements records.

The cash receipts record provides columns for total receipts and their classification is as follows:

Plate Collections

Envelope Collections (Current Expense Portion)

Current Year Pledges
Prior Year Pledges
Special Offerings
Expense Refunds
Benevolence Collections
Current Year Pledges
Prior Year Pledges

Collections on account of prior year pledges, which are comparatively few in number, are immediately divided, in accordance with the terms of the pledges, between Current Expense and Benevolence contributions.

The cash disbursements record, which serves as a check register, provides columns for the several classifications shown above and additional columns for transfers to other funds and for deduction and payment of income taxes withheld from salaries. The last item will be explained later.

Monthly totals are entered in the cash receipts and disbursements records, together with cumulative totals for the year to date. These form the basis for the Treasurer's monthly report to the Board of Trustees which sets forth comparisons of receipts and disbursements for the current month and for the year to date with those for like periods of the preceding year and with the proportionate budget allocations for the current cumulative period.

In addition to the Current Expense Fund, the Trustees have in their custody a Reserve Fund which represents the accumulation of unrestricted legacies and transfers of Current Expense Fund collections over immediate requirements, reduced only by transfers to the Current Expense Fund when the collections for that fund are below current needs. The latter condition is likely to occur during the summer months. The Reserve Fund is deposited in a savings bank, and the passbook serves as a record of receipts and disbursements supported by the minutes of the Board of Trustees.

Churches are relieved of much of the detail that attaches to commercial payroll accounting, but they are nevertheless subject to income tax withholding requirements (except as to salaries paid to ministers, which are specifically exempt) and to the necessity for filing annual information returns. Exemption certificates must be obtained from all employees other than ministers. Individual employment record cards should be maintained to facilitate the preparation of information returns. Salary payments may be recorded individually in the cash disbursements record by entering, as an offset to the net payment, the gross amount under "salaries" and the tax withheld (in red) under "Withholding Tax." At the end of each month a check is drawn to the order of the Collector of Internal Revenue (or a Federal depository) for the total of the amounts withheld, which will balance off the "Withholding Tax" column.

A system of internal control can be effected through the adoption of simple procedures. Dual control over receipts is established by requiring that the collection plates be accompanied from the sanctuary to the church office by two persons designated for the purpose, who will immediately count the loose cash, open and list the contents of envelopes, and prepare a summary of the collection attested by the signatures of both persons. The summary is prepared in duplicate, to provide one copy for the Treasurer and one for the church office. Arrangements having been made with the bank for use of its night deposit facilities, the deposit can be made up at once and placed in the bank's night-drop. If this is not practicable the monies, together with a copy of the summary, can be placed in a locked bag in the church safe, and deposited on the next business day, a copy of the deposit slip, with the bank's acknowledgment thereon, being mailed promptly to the Treasurer.

Payments against pledges are frequently received by mail. These are usually in the form of checks. They are held in the church office safe through the week and included in the regular weekly collection and deposit.

All disbursements are supported by vouchers, except in the case of salary payments which are fixed by special

authorization of the Board of Trustees. In the absence of vendors' invoices, a form of check requisition is provided. This is prepared by the person responsible for the expenditures and, in addition to the name of the payee and amount of the payment, describes the nature of the expenditure and the authority under which the expense was incurred. All vouchers are verified by either the church secretary or custodian as to receipt of goods or services and are submitted for the approval of the chairman of one of the several committees appointed by the Board of Trustees to supervise the various activities of the church.

Disbursements are made by check signed by the Treasurer or Assistant Treasurer and countersigned by the President or Vice President of the Board of Trustees.

The foregoing procedures provide a fairly dependable check on the receipts and disbursements of the Current Expense Fund. In rare instances, contributors' envelopes containing cash are left at the church office, but any discrepancy arising from this source would probably come to light upon receipt of statements sent to each contributor quarterly, showing the total amount of his payments during the current year to the date of the statement. The detailed listing of collections by envelope numbers, from which postings are made to contributors' cards, would help to identify any missing contribution.

An audit of the accounts of the Treasurer may be very readily made under the system outlined. Recorded receipts can be verified by the signed cash summaries of each week's collections and by comparison with the credits shown on the monthly bank statements. Disbursements can be checked to approved supporting vouchers, or, in the case of salary payments, to the minutes of the Board of Trustees. Transfers to the Benevolence Fund are supported by a quarterly statement prepared by the Treasurer which in turn is supported by a summary of the breakdown of pledges as shown by contributors' account cards and summarized thereon quarterly, and the pledges as recorded on the account cards can be test-checked to the signed pledges on file in the church office.

Transactions of the Benevolence Fund consist of receipts by transfer from the Current Expense Fund and periodic payments in support of the several activities earlier enumerated. These payments conform to pledges made by the church body at the annual meeting at which the budgets for both Current Expense and Benevolence are approved, except as to local demands for assistance which, of necessity, are left to the discretion of the Minister acting with the authority of the Board of Deacons and within the limit of available funds.

It should be recognized that the methods of controlling receipts at their source which are described above are not universally adopted nor are really effective substitutes generally employed. In the absence of such control, an audit of receipts is not practicable. The most that can be accomplished by an audit in the latter circumstance is a determination that recorded receipts have been properly accounted for.

This discussion has been confined to a consideration of the receipts and expenditures for the normal operations of a church. It is pertinent, however, to call attention briefly to other financial activities with which churches are frequently concerned. Some of these are of temporary duration, as in the case of projects to raise and administer funds for specific purposes—as the construction of a new edifice or the retirement of a mortgage. Others are of a continuing nature, such as trust funds and endowment funds. The accounting requirements of the former group are quite simple and are dependent upon the particular conditions attending the establishment of the separate funds. The other group falls within the specialized areas of trust and investment accounting, the principles of which are quite definitely established and generally recognized.

Accounting Procedures for the Fruit Grower

By Ezra M. Miller

THE fruit-growing industry, like all industry, has become highly specialized with trained technicians at its disposal. Many small growers have available, through various agencies, the best advice on methods of growing, methods of preserving trees, methods of producing and marketing the product, and many other methods of conducting a successful business. The large fruit grower usually has his own advice in this specialized field. However, very little technical information is available to the grower for the best accounting procedures to be utilized, the many tax advantages, the financial help available, the all-important method of valuation of orchards, the guiding financial statements and the many additional problems connected with management of a successful fruit growing project.

It is the purpose of this article to discuss some of the accounting, tax and financial problems encountered by the fruit grower. Throughout this article reference is made to the fruit grower specifically; however, it should be borne in mind that the general principles are applicable as well to the general farmer and other agricultural enterprises.

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This paper was presented by Mr. Miller at a recent meeting of the York Chapter of the National Association of Cost Accountants.

Nature of Business

The fruit growing industry consists of planting, growing, spraying, harvesting, and marketing the product. The cycle may generally be considered a twelve-month period—actually the season begins in the Spring and ends with harvesting in the Fall; but the marketing may be completed soon after harvesting season or it may be extended into the next season, depending upon the prices available and other pertinent problems confronting the individual grower.

One of the most important problems confronting the fruit grower, especially the larger grower, is the maintenance of "orchard values." This problem is complicated by the fact that different types of trees do not reach the producing stage at the same age. For example, cherry trees begin to bear at approximately seven (7) years of age while apple trees begin to bear at approximately fifteen (15) years of age. In addition, the location of the land, the fertility of the soil, and the individual policy of feeding the trees will have a definite bearing on the value of an orchard at a given time.

For accounting and tax purposes, and for convenience, the growers generally consider the calendar year to correspond roughly with the growing season. Therefore, all costs of growing, spraying and harvesting are considered to be costs attributable to the crop for that year. However, the storing, selling and shipping expense may run into the next year. Thus, if true income and expense is to be accurately computed on a "crop basis," it is obvious that the cash basis of accounting will not serve

as an aid to management. The accrual basis, therefore, is generally used for purposes of management and valuation of properties, even though the cash basis is more advantageous for tax purposes.

General

For purposes of this article, the problems presented and the suggested solutions are based on the premise that there are a number of farms owned by the grower, and that the grower is desirous of knowing the profit or loss *per farm*. It is assumed that apple, peach and cherry trees are maintained at various ages. In addition, some general farming is done on the farms. The owner is desirous of knowing the values of orchards and the profit or loss per farm annually. It will also be assumed that all marketing costs fall within the calendar year.

Use of Code

In order to identify each farm for costs, (expense and income), a simple method of coding will be utilized. This system of coding will also be extended to product and type of operation. This is necessary, in addition to simplicity of accounting, to identify the type of work for the man in the field who does not understand accounting or may not properly explain his activity to definitely charge his time to the proper operation. The code to be used throughout the accounting system therefore, will be as follows:

Farm

A—Apple Hill Farm
B—Red Rose Farm
C—York Imperial Valley Farm
D—Cherry Dale Farm
E—Peach Hollow Farm
etc.

Product

1—Apple
2—Peach
3—Cherry
4—Grain
etc.

Operation

G—Growing—Planting, cultivating, pruning, thinning, etc.
S—Spraying—Mixing spray materials, applying to trees, etc.
H—Harvesting — Removing crops from orchard to packing house.
M—Marketing—Grading, packaging, storage, loading, shipping.

Examples:

A-1-S—Spraying apples on Apple Hill Farm
E-2-H—Harvesting peaches on Peach Hollow Farm

This code may easily be lengthened or reduced to the size needed for any operation. The various symbols will be used throughout the accounting system as well as for financial statement purposes.

I—Operations Accounting

Labor

Probably the foremost problem for the large fruit grower is labor cost and the method to be used for its control and distribution to the proper operation. The labor force is usually divided into groups of six to eight men with a foreman in charge of the work. The foreman receives his orders from a general farm manager who puts into operation the policies of management.

Because of various types of work to be done on the farms with respect to the different types of trees, and at different times of the year, the problem of proper allocation of these costs to the proper operation of growing, spraying and harvesting is always present. Since management desires a breakdown of operating costs *per farm* and *per product* careful attention must be given to receipt of the information from the foreman so that proper allocation can be made. Therefore, the use of the code as outlined above will answer the purpose for cost allocation and can be easily memorized by the foreman. This method eliminates errors and tends to furnish figures that are accurate. A daily report is used by the foreman for the

work of each man under his supervision. This report shows the farm on which the work was done, the nature of the work including the type of trees, the man's name and the hours worked. The report is given to the manager daily for approval and submitted to the office for summary and payment. With this information at hand, on the basis of the code, the cost clerk can charge all direct labor to the proper farm, the proper product and the proper operation per product. Indirect labor is accumulated in overhead accounts and distributed to farms and products on a suitable basis, usually tree population or farm acreage.

Distribution of labor on the basis of the code will enable the accountant to accumulate these costs per farm, per product and per operation for each product. On this basis financial statements can be prepared showing costs of direct labor for growing, spraying and harvesting of all products.

Materials

Fruit growers use large quantities of spray materials, fertilizers, packing supplies and general supplies. Comprehensive reports are needed to determine the quantity, type of material, unit cost, and the farm on which the material is used. Care must be exercised to account for all materials used. Physical examination and test checks should always be utilized to insure against improper usage of costly materials. Control can best be maintained by central storage and distribution as needed for the various operations. It may be advisable in some instances to employ a stock clerk and install a system of requisitioning. The size of the operation will determine whether or not this is necessary.

For purposes of allocation, a separate report for major types of materials used is advisable. All material reports should be prepared by the general manager, because he is best qualified to determine the quantity and quality of materials to be used. The spray materials and fertilizer should be allocated to the proper farm and product in accordance with the code as previously illustrated. These forms should be sent to the office daily for costing, summary, and entry in the cost records.

Management should be provided with a weekly report of materials on hand at the beginning of the week, the materials used during the week, and the balance on hand at the end of the week. A perpetual inventory must be maintained, the method used varying with the size of the operation.

Overhead Costs

General operating costs incidental to the growing, spraying and harvesting can be handled by general overhead accounts. Some costs and expenses, such as repairs to farm buildings, insurance on farm buildings, etc., can be charged to an account applicable to a particular farm. Other costs and expenses, such as, repairs to equipment, packing and miscellaneous supplies, etc., must be charged to a general overhead account and distributed to the farms on a "tree population" or "acreage" basis. Each overhead cost must be considered separately and distribution of each item must be made on the most equitable basis available. For example, farm equipment is used on all farms, for all products sometimes several times a day. Therefore, a general distribution to operations must be made on an equitable basis for such costs as equipment repairs and expenses.

Some overhead costs may be charged directly to a farm. Other overhead costs are so general in nature as to make general distribution advisable. No matter what distribution is used, it should always be kept in mind that the result must comply with the code as previously illustrated. All distributions of costs to operations must be made on the basis of the ability to obtain the results *per farm, per product* and *operation.*

The basis of allocation of costs as outlined above is generally sufficient for all practical purposes for management, as well as, the establishment of costs to be capitalized for appreciation of young orchards.

The costs of Labor, Material and Overhead considered generally above, are treated on a *per farm* basis. There are many variations that may be applicable for individual growers. For example, many growers should keep a detailed packing and shipping record if proper cost control is to be had. Others, because of size, feel that personal supervision is sufficient to overcome cumbersome record-keeping of all packing cost details. The nature and extent of these costs will vary with the size of the operation and the method of selling the product. A detailed record of all fruit packed and sold by types and grade must be kept, however.

Income

Since the sale of fruit is the primary income, attention is directed to records of fruit sold. As indicated above, a record must be maintained of all fruit brought into the packing house. Packing and shipping records must also be maintained. These records should include the number of bushels of each variety and the farm from which received. Allocation of income is made on the basis of these records. Also, audit procedures are available from these records by reference to invoices and bills of lading covering shipment.

Sales of packed fruit should be segregated from sales of bulk fruit. Growers differ in opinion as to the method of handling sales of the latter. One group of growers contend that their primary purpose is to sell packed fruit, and that the sale of bulk fruit is merely a by-product reducing the sale of packed fruit. Other growers take the position that they are in the fruit-growing business and all fruit income constitutes gross income regardless of whether the fruit was sold as packed or in bulk.

The writer believes that the latter position more clearly shows the true facts for several reasons. There is an increasing tendency to sell large quantities of fruit to truckers who transport it to city markets without being packed. Also, it costs as much to grow the packed fruit as the bulk fruit and unit cost studies would be meaningless if all fruit were not included as gross income. In some instances, crops are sold in their entirety as bulk fruit because of hail damage, or some other general condition of the crop.

Income from hail insurance is often encountered, and is usually credited to the sales account. The underlying theory for this basis is that sales would have been much greater had it not been for the hail damage which lowered the grade or quantity. The writer is of the opinion that receipts from hail insurance should be considered gross income and shown separately, and not included in the regular sales account.

Income from grain, as well as from sale of livestock should be considered as gross income under separate headings. All direct costs should also be allocated to separate cost accounts similar to other products in order that gross profit per product may be computed.

Profit from sale of equipment and other miscellaneous income should be considered at the bottom of the Profit and Loss Statement as Other Income in accordance with accepted practice.

II—Fixed Asset Accounting

Accounting for fixed assets of fruit growers is essentially the same as other businesses with respect to buildings and machinery and equipment. However, the establishment of proper values for fruit trees, during the life of the trees, is a major problem for the fruit grower. It is this latter problem that will be considered here.

It has long been the desire of fruit growers to determine accurately the cost of growing a tree to maturity. By learning the age and number of trees in an orchard, one could easily determine the approximate value of the orchard. For this purpose, it has generally been conceded that it costs $1.00 per year to grow an apple tree. However, with the

increased costs of spraying and other materials and fertilizer in recent years, the fruit grower is almost certain to expend two or three times the old basis in developing an orchard. For example, a large fruit grower during 1948 expended the following average cost per tree:

Type	*Average Cost per Tree*
Apple	$3.25
Peach	2.15
Cherry	2.46

Because of the individual policy of feeding growing trees, it is almost impossible to state a general amount upon which growers may rely in the evaluation of a growing orchard. As indicated above, the cost may vary from a generally accepted average of $1.00 per tree to $3.25 a tree in an actual case in 1948. Based on several years experience, and other available information, the writer believes that each case must be considered separately before arriving at an average value per tree for an orchard, and that the policy of feeding the tree and general maintenance of the orchard must be given full consideration in arriving at this figure.

As previously indicated, the grower should know the value of the various orchards at the end of each year. In order to arrive at this result, several problems must be considered. The following factors enter into the consideration:

1. Type of tree.
2. Cost of original tree.
3. Life expectancy.
4. Time before bearing begins.
5. Time depreciation should begin.
6. Time depreciation should end.

In view of the fact that many fruit growers file their income tax returns on a cash basis, the valuation problem is confined to the accrual basis of accounting. Hence, the method used here will be considered for management purposes only and will have no connection with valuations allowance or disallowance by the Bureau of Internal Revenue.

The formula suggested here is based on the presumption that all trees are very well fed, and all orchards are expertly maintained. At present, research is attempting to bring trees into bearing at an earlier age. However, until this is proven, there should be no consideration given to a longer bearing period for purposes of appreciation or depreciation of the orchard. It should also be kept in mind that conditions at various locations may alter the facts to the extent that a change in formula is advisable.

The following guide may be used for fruit growers:

Apple Trees

These orchards increase in value for the first fifteen (15) years. For these fifteen (15) years the apple trees bear some fruit but, not enough to maintain them. From fifteen (15) to twenty (20) years the trees increase in value and bear fruit, the income from which will just about equal the cost to maintain them. From twenty (20) to thirty-five (35) years the trees yield their best crops of apples. After thirty-five (35) years the trees again decline to a point where they will pay only for maintenance. They are destroyed after that time depending on the condition of the trees. In some cases, trees bear fruit until age forty-five (45) and older. In other cases, trees discontinue bearing fruit soon after the thirty-fifth year, depending on the circumstances in each case.

Formula:

1. Capitalize the cost of the original tree.
2. Where actual figures are not available to establish the value of the orchard, capitalize each tree less than fifteen (15) years of age at $1.00 or $1.50 per year.
3. Where actual figures are available, capitalize each tree for the

first fifteen (15) years at actual cost.

4. All cost of maintenance from fifteen (15) to twenty (20) years of age should be charged to expense.
5. Depreciate the value of the trees over a fifteen (15) year period commencing with the 21st year and charge maintenance to expense.
6. After thirty-five (35) years of age, the maintenance of the orchards should be charged to expense.

Peach and Cherry Trees

These orchards bear very little fruit for the first seven (7) years. From seven (7) to ten (10) years, they bear enough fruit to pay the expense of maintenance. From ten (10) to twenty-five (25) years these trees yield their best fruit, and after twenty-five years, they decline and are removed, depending upon their usefulness after the twenty-fifth year.

Formula:

1. Capitalize the cost of the original tree.
2. Where actual figures are not available to establish the value of the orchard, capitalize each tree less than seven (7) years of age at $1.00 or $1.50 per year.
3. Where actual figures are available, capitalize each tree for the first seven (7) years at actual cost.
4. All cost of maintenance from seven (7) to ten (10) years of age should be charged to expense.
5. Depreciate the value of the trees over a fifteen (15) year period commencing with the 11th year and charge maintenance to expense.
6. After twenty-five (25) years of age, the maintenance of the orchards should be charged to expense.

An appreciation and depreciation schedule should be maintained containing the following information:

Farm code
Type of trees
Age of trees
Number of trees in the orchard
Cost of trees
Gross book value beginning of year
Increase in value during year
Adjusted gross book value end of year
Current depreciation
Total allowance for depreciation to end of year
Net book value of orchard end of year

From the above information, management can determine the facts necessary for managerial and credit purposes. Additional information can be added for values of land and buildings not included in the orchard values. This information may also be valuable for estate tax purposes as well as determination of proper sales values in case management desires to sell any part of the orchard holdings.

Conclusion

It is not the purpose of this article to establish set rules for orchard accounting or to indicate that the methods suggested are the only ones used. Rather, it should be considered in the light of workable methods which are used in certain cases, and which might be applied to fruit growing operations elsewhere. The same general principles might be applicable for general agricultural use, modified of course, to suit the particular case. If considered in this light, it will have served its purpose.

Brewery Cost Accounting

By Herbert C. Geyer

The cost accounting process for breweries should be set up so as to yield the most accurate departmental cost figures while, at the same time, expediting the checks and controls for the inspectors of the federal and state agencies, who are interested in collecting the amount of taxes due. For convenience, and for the reasons stated above, we classify our accounting procedure as to departments under the following headings:

1. Service or non-production departments:
   a. Building department.
   b. Water department.
   c. Power department.
   d. Refrigeration department.
   e. Trucking department.
2. Brewing or production department.
3. Cellar—aging and/or storage department.
4. Packaging department consisting of:
   a. Racking.
   b. Bottling.

Herbert C. Geyer was born in Frankenmuth, Michigan, and received his elementary education in that community. Following service in World War I, he attended Bliss Alger Business College in Saginaw. For about fifteen years Mr. Geyer was employed in banking in Detroit and Flint, during which period he pursued courses conducted by the American Institute of Banking and Columbia University. Since 1938, he has been connected with the Frankenmuth Brewing Company and at present holds the position of Auditor and Controller. Mr. Geyer is a member of Saginaw Valley Chapter of N.A.C.A.

This paper was presented by Mr. Geyer at a meeting of the Saginaw Valley Chapter of N.A.C.A., in connection with a plant visitation at the Frankenmuth Brewing Company.

1-a: All expenses in connection with the maintenance of the plant buildings, general plant supervision, labor, compensation insurance, social security taxes, materials used for maintenance and repairs, plant fire and extended coverage insurance, real estate taxes, and items of repair not directly affecting any other department are charged into accounts classified under the building department. It is unusual to carry considerable amounts of building supplies on hand and, for that reason, we do not find it necessary to carry a monthly inventory under this department. The total accumulated expense of this department for the month is charged to the other service, production, storage, and packaging departments on the basis of either floor area or the cubical contents of all buildings.

1-b: The water department, in our case, covers our own water purifying plant, operation of pumps for cooling ammonia condensers, pumps on our deep wells, and water purchased from the city for special use. As is the case in the building department, all expenses in connection with the operation of the water plant and its equipment, such as supervision, labor, social security taxes, compensation insurance, direct repairs, supplies used, and depreciation on the filtration building and equipment, as well as the proportionate share of electrical energy used in operating the pumps and machinery, are charged into expense accounts set up under this department. After the total accumulated expense for the water department has been determined for the month, it is transferred on the basis of water used into the subsequent service, production, storage, and packaging departments.

1-c: The power department expenses are similar in nature to the expenses of the prior two departments. In addition to these, we charge this department for fuel, water compounds, and other supplies used during the month. The total accumulated expense of the power department is then charged on a percentage of use basis against the production, storage, and packaging departments. Since the packaging departments include the operation of washing and sterilizing of kegs, bottles, and pasteurizing of can and bottle beer, we therefore charge the percentage of expense for use of power to these departments.

1-d: In the refrigeration department, we again have direct expenses similar to the departments previously mentioned and, in addition, charge the proportionate percentage of the electrical energy as well as the amounts which had been transferred as a charge from the building and water department. Since the departments which are supplied with refrigeration show a very considerable variance at the different seasons of the year, we have determined an over-all fixed percentage covering the entire year, and charge the accumulated expense for the month on this basis against the production, storage, and packaging departments.

1-e: The trucking department in our case is of minor inmportance, since we account for the expense of operating our yard trucks only. The hauling of materials and supplies to the plant is performed by private carriers and contractors, and all cartage and freight expense incurred is charged direct to the various materials and supply accounts. Since we do not deliver any finished beer from our plant direct to the trade, we are in this respect unlike most of the other operating breweries. The expense which is accumulated in operating our trucks during the monthly period is charged on a percentage of benefit basis against the production and other departments.

2. In the brewing or production department, similar to the service departments, we have regular items of direct expenses, such as supervision, labor, social security taxes, compensation insurance, materials, supplies, direct repairs, and depreciation of equipment; also, the proportionate amount of electrical energy and the prorated building, water, power, refrigeration, and trucking expenses which have been transferred from the service departments.

Since it is required by the Alcoholic Tax Unit that every pound of raw brewing material be accounted for, we keep a perpetual inventory on all of these items. It therefore serves as a double check on the materials used in production, since these are reflected in the quantity of wört produced, and this is checked by the federal inspectors on the basis of yield. In this department the first of various taxes makes its appearance, since we are required to pay a five cent per barrel Michigan state tax on the net monthly brewhouse production. The total expenses of the items under the brewing department, less the receipts for the spent grain, is transferred as a charge to beer delivered to storage cellars. We divide the total accumulated brewing expense by the total production to arrive at the cost per barrel produced. Since the barrel is the unit of measure used throughout the production and packaging department, all federal and state excise taxes are assessed on this unit basis. The barrel by government standards consists of 31 liquid gallons.

3. The storage and/or aging cellars are maintained by us as a distinctly separate department. Any expense in connection with the operation of the cellars such as supervision, labor, compensation insurance, social security taxes, building and machinery repairs, depreciation of equipment, and the proportionate charges previously allocated from the service departments, plus any incidental expenses, materials, and supplies used and, in addition, the prorata charge for the electrical energy are expensed into this department.

We arrive at a per unit cost for

handling the beer in transfer and storage by dividing the total accumulated monthly expense by the number of barrels processed during the month. Because of the necessity of properly aging beer, we find that our beginning inventory of beer in storage has a twofold unit cost, namely, the cost of beer plus the per barrel handling charge in storage during the previous month. Since we follow the method of first-in—first-out, we inventory the production of the present month at the calculated brewhouse cost plus the handling charge per barrel for the total quantity processed during the month. In addition, we will have the value of the unused beer from the previous month, which may have a different brewhouse cost and in which is included the handling of that beer for the previous and present month to give it its current inventory value.

Having thus established the ending inventory as above outlined, we now charge against the packaging departments the total balance of expense and residual value of the beer on the basis of the number of barrels which had been transferred to each department during the month. Since there is a loss and waste in handling the beer in the aging and storage cellar, we find that by our method of computation we will automatically add to the cost of beer transferred the factor of expense of these losses, and we will therefore not overstate our ending inventory.

4-a: The racking department is the first department classified under packaging, and it is here that the beer is kegged or barreled. This department is charged for the total value of the beer transferred from the storage department. In addition, we add the expense incidental to packaging such as wages, social security taxes, compensation insurance, depreciation of equipment, supplies, as well as the charges from the service departments and for electrical energy used. By dividing the total number of barrels packaged into the accumulated departmental cost plus the cost of beer from storage, we arrive at a unit cost of production per barrel for this department. Having thus established the unit cost, we proceed to inventory the finished beer on hand at this cost. The balance of the accumulated expense, excise taxes, and cost of beer is transferred to the respective cost of sales accounts. Before the beer is removed from this department, we are required to affix the federal, Michigan and/or excise tax stamps for the state into which the beer is to be shipped.

4-b: The second department under packaging (bottling and canning) requires a little different method of approach in arriving at the unit costs, since the beer used in bottling has been transferred into government storage tanks and the state excise tax is paid as the beer is transferred into these tanks. For that reason these taxes become virtually a part of the packaging cost. Inasmuch as we handle distinctly different packages against which the item of cost applies, we separate these expenses into bottling and canning. For convenience and more accurate accounting purposes, we subdivide all of the departmental expense accounts under three categories: namely, general expense (expense applying to bottling and canning on a similar unit cost basis), bottling expense, and canning expense.

Under items of general expense we charge supervision and wages, building and equipment expenses, repairs on machines and equipment used for both packages, compensation and other insurance applying thereto, sundry supplies, electrical energy charge for operating the department, and the service department expenses applying to the production of both packages. Under bottling expenses we have such items applying directly to this operation as production wages, compensation and other insurance, crowns, labels, cartons used, bottles broken, and sundry supplies. In arriving at the total expense for canning we again charge such wages, compensation and other insur-

ance, cost of cans and cartons, lids, sundry supplies, etc., in order that we may compute the direct canning expense.

By this method of separating the expense in connection with the two different packages we are able to determine the exact production cost of each. We now charge to the individual packaging the unit cost of beer used during the month in the department. Since the state excise taxes are assessed on the per barrel basis, they would be chargeable to the package on the yield obtained during packaging. In the operations where we use a tax-paid crown for another state in packaging, we automatically add the value of this excise tax per case against the units thus produced. It is self-evident that extreme care must be used both in inventorying and charging cost of sales with the proper amounts where the packaged beer involves a great number of states with their different excise tax rates. In the case of state excise taxes, losses would be charged against the cost of sales for the respective states.

Having thus arrived at the cost of sales of our packaged products, we charge the respective cost of sales accounts; and, in our case, we maintain a separation of each type of package and each state in which the respective packages are sold. Since we record our sales in the same manner, we find it easy and convenient to show the gross profit on each type of package in the respective state in which the beer is sold. In spite of the many details that are involved in brewery accounting, we find it interesting and informative to maintain accurate departmental costs for comparison and to make management decisions.

Ordinary details are involved in setting forth the selling, advertising, and administrative expenses. These can be subdivided under different expense account headings to conform with the desires of management. In line with this thought, we do not charge any overhead from these departments into production. Due to the many federal and state taxes and the competitive nature of the brewery business, which leaves a small margin of profit per unit, it is necessary to keep a detailed and accurate cost accounting system, and no effort should be spared in setting up and maintaining it.

Distribution Costs in the Bottling Industry

By JACK L. CALDWELL

TO the unitiated observer, the cost of distributing bottled products would appear to be a simple computation: merely divide the total cost of distribution by a common product denominator, such as gallons or cases, and *voila!*—cost per unit! The answer thus derived may be interesting and useful in statistical analysis, but it is not sufficient in evaluating actual cost for a diversified bottling operation. Low margin per unit on a variety of bottled products means that further refinements are necessary.

Certain problems of the bottling industry are typified by our company operations. Our bottled products are diversified; we bottle and distribute natural spring water, carbonated water, and distilled water. The sizes of standard containers include cases of six ⅔ gallon bottles, four 1 gallon bottles, six 1 gallon bottles, six 36 ounce bottles, and a crate containing one 5 gallon bottle. These containers are not the disposable type and must be picked up for return to our plant. The quantity delivered to one customer in a single truck delivery ranges from one case to a truckload of over one hundred cases. We also deliver in barrels and up to 750 gallons by tank truck. Our customers include manufacturers, wholesalers, retailers and consumers, and distribution is accomplished mainly by our own trucks. However, we do have sales at our plant and out-of-town shipments by freight carriers. Customer deliveries by truck from our plant may range up to 40 miles one way, and the products, size of case, and total quantity delivered may vary by every possible combination within the capacity of one truckload. All of our regular drivers are paid on an incentive wage plan and each driver may encounter all of the above-enumerated variables within each weekly pay period, with the exception of tank truck and barrel orders, which are normally special deliveries.

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Mr. Caldwell's education at Ohio Wesleyan University was interrupted by three years of service with the U. S. Army Air Corps. He completed his undergraduate work at the School of Business Administration of the University of Minnesota, where he was awarded the degree of Bachelor of Business Administration, with distinction, and was elected to Beta Gamma Sigma and Beta Alpha Psi.

This paper was recently presented to the members of the Twin City chapter of the N.A.C.A.

Definition of Distribution Cost

Distribution cost, as we define it for this paper, includes the costs to transfer the product physically from our plant to the customer and secure the return of the empty container. In this respect, the costs common to the bottling industry are truck-driver wages in the form of labor cost, truck operating expenses, and the functional cost of loading and unloading trucks. We do not include the customary selling expenses, such as advertising or sales salaries, because they are not a direct cost of product physical movement, nor do they bear any relationship to the distribution cost of specific products. Actually, the driver is a salesman who solicits and accepts orders for our products but this "selling" expense is directly related to his delivery produc-

tivity, and its inclusion in distribution cost introduces no significant departure from our definition.

There are several objectives in determining our distribution cost. The interaction of the multiple variables affecting delivery cost causes a wide variation in total cost by driver—weekly, monthly, and annually. Our problem essentially is to break down this gross cost figure for the period into that portion of the cost applicable to each specific type of product by size of container. It has always been obvious that the case of six ⅔ gallon bottles of natural spring water delivered primarily in small quantities to residence customers is more costly per unit than the case of six 1 gallon bottles of distilled water delivered in large quantities to our distributors. There are many other comparisons showing distinct cost differences. To segregate the various per unit costs and at the same time maintain an incentive wage plan which is fair to both labor and management, we have drawn upon a variety of cost accounting techniques. We attempt to establish product unit costs for price and profit determination, as a "benchmark" in negotiating driver hourly wage contracts, and for the establishment of a mutually beneficial incentive payment plan.

The only practical method of measuring quickly the oscillations in cost appeared to be a process cost system. The distribution of our product is a continuous and relatively repetitive procedure; the volume is large, and the margin small. Although a job order system would ultimately produce a cost for each combination of variables, it would be highly impractical to compute and would represent only historical cost with little indication of trend or seasonal variation.

Selection of the Homogeneous Unit

Our first step was the acceptance of a homogeneous unit for fundamentally gauging the relation of total distribution cost to the volume delivered in a given period; this is our benchmark, or over-all average cost. Sales, expenses, profit, volume of production and delivery, budgets, truck capacities, and many other factors are based on our smallest integral unit of product, the *case*. Selection of the case is perhaps a foregone conclusion. Gallons or bottles delivered would not be a logical unit because of the difference in quantity in different size cases. Certain other bottled product distributors might logically select another uniform unit such as tankloads, truckloads, or specific case lots, where these units are the standard minimum delivery.

Labor cost of distribution is the important factor deserving the most critical analysis. In our operation, it is by all odds the most complicated cost to analyze as well as the most fruitful. Wages comprise almost the entire total cost of distribution, with truck operating and loading expense running second and third respectively. This relationship compels a careful control over labor cost since there is not sufficient economy possible in the smaller items to offset even minor increases in driver payrolls. Incentive pay plans under certain conditions may be factors in wage cost stabilization. The primary requisites of an acceptable incentive pay system are its legality under government regulations and its approval in union negotiations. Satisfaction in contract bargaining usually hinges on at least a minimum guarantee based on hourly rates or "work week certain," providing fringe issues concerning individual driver inequities may be satisfactorily resolved.

Compliance with government regulations is an entirely separate study in itself and readers are cautioned to consult legal counsel before instigating or materially altering an incentive wage system. In order to justify the use of the specific commission arrangements discussed hereafter, the two major conditions in regard to government regulation are very briefly outlined. First, the simpler situation where employees are not subject to Federal Wage and Hour Acts, or, employees are subject

to the Act but payments qualify as exempt from "overtime on overtime" provisions. Secondly, the problem when employees are subject to these statutes and "overtime on overtime" regulations do prevail. We are at present operating under the latter condition, and the key to the difference in methods of payment is the application of, or exemption from, "overtime on overtime." Concisely, this provision requires that the incentive portion of the wages be *included* in computing the base rate for the purpose of computing time and one-half for overtime hours. Or, from another viewpoint, the incentive pay is presumed to be straight-time pay and overtime must be computed at 150% of the straight-time incentive rate. Management in many instances ignores this provision in the mistaken belief that any extra pay in excess of their current pay scale or union agreement is "icing on the cake." The fallacy, of course, is that the more wages paid in violation of "overtime on overtime" provisions, the greater is the company liability for pay in arrears. An illustration of this computation will be given under incentive pay computations.

Incentive Pay Exempt from "Overtime on Overtime"

Several methods are currently employed as a means of increasing the productivity of delivery drivers, and the use of incentives is generally recognized as valuable in distributing bottled products locally by truck. Under the first condition, without regard for "overtime on overtime," a relatively fixed flat piece rate is commonly established for each homogeneous unit delivered. This commission may be correlated individually to various products or to various route conditions. The flexibility of a per unit commission permits management to adjust or establish the rate with reasonable cognizance of the difference in cost to accomplish different deliveries under a variety of variables. Piece rate commissions are normally a result of statistical analysis of annual per unit costs as derived from quantity delivered, hours worked, and gross pay. Consideration of figures for the entire year is required where seasonality injects still another variance in cost analysis. Where this method is used, union agreements ordinarily specify that incentive pay must be compared to hourly pay, and the employee must receive the larger amount, except where the incentive is wholly additional to hourly pay.

Variations in this method include establishing a minimum daily or weekly pay plus the stipulated piece work commission. This minimum pay provision may or may not require the exclusion of a portion of the driver's deliveries from the commission computation for the period. In either event, this minimum pay may act as a cushion to absorb changes in the guaranteed minimum as established by union agreement without necessitating a change in the per unit commission.

A typical example of the use of piece rates might be constructed as follows: The driver is to be paid a minimum of $48.00 for the first 400 cases delivered, plus an incentive pay of 10¢ for each additional unit delivered.* If the driver delivered 600 units for the period he would receive $48.00 plus $20.00 commission, or a total of $68.00. Assuming this was accomplished in 50 hours and the union agreement stipulated minimum pay as $1.00 per hour with time and one-half after 40 hours, the employee would earn $13.00 more than required by contract rates by incentive pay computation.

In the example given, no complications were introduced for more than one major product where delivery time is materially different, and the quanti-

* In order to provide for the return of empty containers, a "unit delivered" may be defined as including the return of one empty container; or, a specific number of empty containers may be established as the equivalent of one "unit delivered."

ties delivered vary considerably from one pay period to another or between individual drivers or routes. To allow for an established difference in the number of units of product "A" or "B" delivered per hour, the commission rate may be varied for each product. Product "A" might earn 12¢ per unit, indicating a slow delivery per hour because of smaller quantities normally purchased by each customer. A product "B" commission rate of 9¢ per unit would represent a delivery rate 1.33 times as rapid as product "A"; this item might be delivered to a regularly established clientele on a "keep supplied" basis. In utilizing one or more individual product commissions it would be necessary to adjust the $48.00 minimum in the previous example, or establish a scale of variable minimums depending upon the quantities of products "A" and "B" delivered during the period. The opportunities for varying an incentive of this type are unlimited and, except for illustrating bottling methods, no other examples need to be cited.

The fixed piece-rate method essentially establishes a per unit cost closely akin to a standard cost. In the example where the product was uniform in delivery cost, the first 400 cases per period per driver would cost 12¢ with a gradually declining average cost where subsequent commission deliveries were made at 10¢ per unit. The quantity delivered beyond the 400 case minimum would create a favorable variance from the standard of 12¢, whereas if the driver hourly pay exceeded incentive pay computations for any period an unfavorable variance would result. In utilizing a system similar to this the management does obtain a benchmark cost quickly related to current actual cost. A further purpose is served since any new products introduced or other changes in delivery variables will be reflected by the degree of variance. Conservatism should dictate the formation of any new incentive pay installation and savings require continual review of current commission rates in an economy of fluctuating wage rates, sales, and other expenses, together with progressively better methods and equipment. Truck operator distribution is losing if a "horse-drawn" incentive is employed.

Incentive Pay and "Overtime on Overtime"

The cost accountant who is confronted with required overtime hours and "overtime on overtime" pay regulations combined will generally conclude that the two are irreconcilable with accurate, confident cost determination. If the overtime hours vary, or are relatively uncontrollable, such as highly seasonal bottling distribution with definitely limited trained personnel and delivery equipment, the accountant will be technically correct in that first assumption. Under these conditions, even hypothetically identical situations will produce a new cost in the form of "overtime on overtime" and the average weekly cost may bob like a cork on choppy water. Historical costs, of course, may still be ultimately determined but in the role of prognosticator of changes in wage unit costs, overtime hours, and incentive wage plans the problem becomes mathematical.

The following brief illustration of incentive pay and "overtime on overtime" cites the problem involved and the amount of error in wrong computations:

	Contract hourly rate	Incentive earned per hour	Hourly base rate	Rate per overtime hour	Add: Incentive earned	Pay for one overtime hour
CORRECT	$1.00	$.20	$1.20	$1.60	$.20	$1.80
WRONG	1.00	.20	1.00	1.50	.20	1.70
"Overtime on overtime" due the employee in *wrong* computation						$ .10

One method of compliance is to perform the *correct* calculation illustrated to determine the base rate for each employee for each pay period. The additional cost is either absorbed by the company and reduces their savings, or is absorbed by the employee reducing the incentive earned in each straight-time hour to compensate for the premium on overtime incentive pay. Where the incentive pay is easily calculated per hour and the initial computation will determine the pay for a large group of employees (such as a group bonus) this method may be the most suitable. However, where the payment to every driver each week is heterogeneous this computation for each driver would place an added burden on our payroll department and no useful information would be provided.

Heretofore, our driver pay was comprised of a minimum guarantee plus an incentive amount for each unit delivered. Therefore, as advised by counsel, to comply with federal regulations we were confronted with the problem of revising our incentive payments. The system we selected and have incorporated for almost a year is reasonably simple to apply, and provides valuable information of per hour output. By a complete revision of our incentive plan geared to achieve the same end-result to the employee we were able to retain savings already attained by the use of incentives.

We compute the regular hourly pay plus overtime premium for total hours worked in the accepted manner; overtime is effective for all hours in excess of 40 hours per week. We apply our incentive pay as a percentage of gross hourly pay thus computed. The percentage commission earned is directly related to the number of units delivered per hour by each driver. With this process we distribute the amount of the commission, or incentive portion of driver pay, proportionately to his straight-time and overtime pay. In other words, the percentage commission for straight-time hours is increased one and one-half times when applied to pay for overtime hours. Obviously this does not avoid the awkward 50% increase in incentive cost for overtime hours which must be accepted under these regulations with the same placidity as time and one-half after 40 hours. However, this method permitted us to establish the percentage at equitable rates, comparable to our past cost experience. It gave us insight into heretofore untapped information concerning driver per hour output, and this in turn became an ideal oscilliscope for observing the direct effect on specific product distribution cost of all of the variables mentioned in the introduction.

In our procedure, each driver must attain a minimum number of cases per hour for all hours worked before any percentage commission is earned. Since our cost naturally increases after 40 hours have been worked, this minimum number of cases is increased by one additional case per hour after 40 hours. If necessary, further additions to the minimum could be introduced at yet another point in overtime hours worked, but we did not consider this advisable. The computation of "cases delivered per hour" is merely the total cases delivered for the week (and its equivalent in empty containers returned) divided by the total hours worked. To determine the percentage of commission, our scale for incentive pay would appear similar to this:

	Commission percentage of Gross Pay	
Average cases delivered per hour	40 hours or less worked	More than 40 hours worked
1 to 10	-0-	-0-
11	3%	-0-
12	6%	3%
13	9%	6%

Chart of driver incentive pay percentages.

The minimum number of average cases per hour is 10 for 40 hours or less, and increases to a minimum of 11 thereafter. There are also a host of variations which may be embodied in this method. For example, a declining percentage could be employed, effecting

savings in average cost as additional units were delivered. Or, the percentage could decline as additional hours were worked in excess of 40 hours per week, allowing the minimum to remain constant.

Other Distribution Costs

The remaining distribution costs are truck operating costs and loading-unloading trucks. The cost of operating a fleet of trucks has been competently treated elsewhere, and we use generally accepted cost principles to determine our costs of operation per truck per mile. Operating and maintenance costs are charged directly to each truck and periodic mileage checks are made. Each driver on our regular routes uses the same truck at all times except during repairs and, therefore, the equipment costs relative to his particular deliveries are neatly isolated. This permits us to compute the trucking cost per mile for each driver and thus apply this cost to units delivered. Average miles traveled for each unit delivered indicates the differences in route area, travel time involved, and also reflects quantity delivered at each stop. Mileage costs are not significant in relation to specific products and we have made no attempt to determine a distinction (if one exists) between average miles traveled to deliver one specific product as opposed to another. This does not appear to be valuable where each product price is established uniformly for the entire area served. Average miles traveled per driver working hours is also an indicator of customer density and route area.

To summarize truck distribution costs, we apply this cost equally to each "case delivered" regardless of product contained or gallons per container—it is applied to our homogeneous unit, the case. Theoretically, a large volume delivery to the retailer or a single case delivery to a consumer involves a joint cost; the saving made in the volume delivery is labor hours—the truck trip was necessary in either instance regardless of quantity delivered or type of product.

The cost of loading trucks consists mainly of labor to load and unload at the plant dock. This cost is also computed per case regardless of product or container size. This appears to be a logical cost technique, since the truck loads are mixtures of all products and all size cases. The case dimensions and construction are sufficiently comparable so that all sizes require almost identical handling, and variance in weight of cases does not have a significant influence on loading labor cost.

Analyzing the Effect of Variables on Labor Distribution Cost by Product

The variables mentioned in the introduction primarily affect only the labor cost of distribution. Therefore, where the circumstances are similar to the variety encountered in our operation, it is inconclusive to accept the "benchmark" (average or standard) cost per case as the ultimate actual cost for all products and case sizes. The purpose and value of this average is primarily statistical, in addition to its incentive wage functions.

The information which we wish to obtain from the breakdown of this average may be stated generally as follows:

1. The effect of size of case on average deliveries per hour.
2. The effect of sales of distilled, spring, or carbonated water on average deliveries per hour.
3. The effect of distance traveled on average deliveries per hour.
4. The effect of large volume deliveries on unit cost.

It will be noticed that each of the problems is posed in terms of two variables. Also noticeable is our prominent use of "average deliveries per hour," derived as a by-product of the incentive wage plan, for measuring the efficient utilization of labor hours. Where overtime plus "overtime on overtime" are factors regularly unavoidable, this criterion as-

suredly becomes of foremost importance.

Further analysis is greatly facilitated and results are more readily acceptable to management outside of the accounting field by resolving the problem into terms of two variables. Thereafter, it is purely mathematical and the solution may be obtained by various methods. Among the more familiar methods employed are simultaneous equations, ratio analysis, and diagrammatic or scattergraphs.

The information which we accumulate for these statistical studies is total quantity delivered segregated into kind of product and size of container, total hours worked, gross pay, average cost per case (all cases), average deliveries per hour, and mileage traveled. The relationship between any of these factors for the period or driver under review is then readily obtainable. Charting these relationships by designating one variable on each axis, plotting the relationship for a significant period, and projecting the slope of the line of correlation to either extreme discloses the theoretical situation.

The effect of large volume deliveries requires special study beyond our normal routine, since the number of customers served during any given period is not directly accessible in our regular driver check-in procedure. Average cases delivered per customer is the factor which we relate to average deliveries per hour in analyzing this aspect of unit cost. One of the purposes for studying the effect of large volume individual deliveries is its factual approach to the determination of quantity discounts. Here again, legality is of prime importance where price concessions are governed by fair trade acts. The points of progression of quantity discounts should represent clear-cut demarcations in product delivered cost. The process cost approach with its customary averages does not provide pronounced changes in cost although it will indicate the range and slope of cost changes. A job order type cost analysis may be desirable in situations which lend themselves to time study, such as our irregular tank truck special deliveries.

In computing many of our relationships, we must be selective of statistics used, particularly where kind of product or size of container are involved. In order to eliminate or minimize the effect of extraneous variables, we must select data only from certain drivers or during specific seasonal periods to isolate reasonably the two elements under observation. As soon as a mathematical relationship is established between two components, the total time or total hourly cost involved may be broken down into its respective parts. For instance, if the rate of delivery of product "A" to product "B" is two to one (2A equals B), and two units of product "A" plus one unit of product "B" are delivered for a total cost of $1.00, the unit cost of product "A" is 25¢ and "B" is 50¢. Algebraically:

$$\begin{aligned} 2A - B &= 0 \\ \underline{2A + B} &\underline{= 1.00} \\ 4A \quad &= 1.00 \\ A \quad &= .25 \end{aligned}$$

This same procedure is followed in analyzing each variable desired.

Conclusion

We have been able to discover an increasingly valuable storehouse of information concerning our various product costs by employing the techniques described. Many of the ultimate results merely crystallized and pinpointed foregone conclusions, but our greatest satisfaction and benefit has been the disclosure of heretofore unrealized aspects of distribution costs. The principles which we follow could be applied, of course, to many other similar distribution operations outside of the bottling industry.

CORRESPONDENCE

To the Editor of *The New York Certified Public Accountant:*

I should like to reply briefly to the letters of your two correspondents, which appeared in the October, 1950, issue.

Mr. Greenblatt's letter claims that, in suggesting a solution, I have given precedence to "legal and economic factors" at the expense of certain accounting conventions. The solution I present gives due regard to the "legal factor" (which I take to mean that the company is not liable on the mortgage) as I think it should. The "economic factor", however, does not enter into the solution; it is merely a force affecting operations the results of which are reflected in the accounts. I believe a balance sheet should be drawn up so as to present fairly the financial position of a company. In this case the company is an owner of "equities" in real estate and as a going concern has no intention of owning such property outright. There is no liability on the mortgage. To present the financial position with respect to the property and mortgage it is best presented as I suggest. The problem is not one of trying to reconcile certain legal and economic factors with accounting conventions; rather it is one of trying to present the financial position (in accordance with generally accepted accounting principles) in the light of certain legal facts and economic forces.

It is not quite clear to me what the second paragraph of this letter is getting at in saying it is erroneous to segregate the real estate from other assets in the balance sheet, unless it is intended to mean that the "net amount" carried into the assets is zero. Here again, all the facts affecting the property are presented in accordance with the principles stated above.

Regarding the treatment of the "excess of mortgage over net property account" there is no question, or should be no question here as to a "conflict" between accounting convention and "economic facts." We are dealing with certain facts, namely that the property value has risen and we have obtained additional cash through increasing the loan. Our objective then should be to develop a balance sheet presentation (accounting convention, if you will) to reflect the facts in accordance with generally accepted accounting principles. I might add that I have been advised by a member of the society that the treatment used by one of his clients is to recognize the excess of the mortgage (in this case arising through depreciation) as an increment in the amount at which the property is carried and to include on the credit side of the balance sheet, under "Surplus Reserves," an item "Surplus arising from revaluation of fixed assets" of an equivalent amount. In this case it should be pointed out, the "market value" of the property was considered to be in excess of the written up amount carried in the balance sheet.

Other factors referred to, such as increased interest, taxes, amortization, etc., would appear to be in the same position under either treatment.

As to Mr. Kronthal's letter, the intention of my article was primarily to present the main principles involved in the problem. It was recognized, however, that unpaid taxes and mortgage interest represented one of the many complicating factors which might be encountered and it was mentioned primarily in that light.

Very truly yours,

A. M. Stollmeyer

New York, N. Y.

Design and Installation of an Accounting System for a Chain of Grocery Stores

(A Case Study)

By RICHARD F. JONES, C.P.A.

THE primary difference between grocery store operation and other retailers is that a sales audit is impractical beyond a simple departmental classification, such as groceries, meats, vegetables, etc. This limitation must be considered in evaluating the other sources of information in the business and the requirements of executives for data for administrative purposes.

It is also a basic assumption that each store is to be considered a separate enterprise with consequent need for individual accounting for results. Subject to practical limitations, therefore, all transactions must be keyed to reflect the individual stores involved as well as proper classification for the over-all chain records.

Inventory Records

Inventory records were chosen as the starting point in the design of the system for several reasons. As stated previously, sales are not subject to analysis by the accounting department. The turnover of inventories, including detection of slow moving stock, allocation of inventory capital, etc., must be controlled by the purchasing department, supplemented by physical observation in the stores. Store inventories are usually taken during business hours with the result that speed in taking is required to offset possible errors because of stock movement and sales. Therefore, the store inventory is controlled only at total retail value, and inventory differences cannot be investigated in the stores. The many possible factors in shortages such as theft by customers, unrecorded spoilage, errors in price changes, clerical errors in registering sales, employee dishonesty, etc., are not subject to accounting control. Consequently, since responsibility for the inventory rests so completely with the store manager, it is necessary to insure absolute accuracy in perpetual inventory records to avoid alienation of valuable employees by mistaken shortage reports.

The problem was further complicated by the fact that the client operated two types of stores, each with its own price structure. Small service stores carried fewer items than large supermarkets, with the further variation that some of the smaller stores did not have a meat department. Goods were received directly in the stores from suppliers of a large percentage of merchandise, including meats. The majority of purchases, including produce, were stocked in a central warehouse and delivered in the chain's own trucks. In a few instances, managers were authorized to pay cash for merchandise. For all store deliveries, the manager was required to obtain an invoice which he signed as authorization for payment or his receipt if he paid cash. For deliveries from the warehouse, the manager used a printed order form which also showed the current price of all items listed. This order form corresponds with the layout of the warehouse stock to facilitate filling of orders.

Since the invoices received for direct store deliveries by vendors constituted the larger part of the items to be handled, it was decided to make them the

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basis of the inventory and accounts payable records. The manager is required to enter the unit retail price on each invoice he approves. The manager's order form was printed with columns showing, for each item, the number of units ordered, the number shipped, unit price and the total retail value. On an extension strip on the side, the columns were repeated for units shipped, unit price and extension. By tearing through perforations, the extension strip was available for use as a shipping record, while the manager's order, corrected for changes in the warehouse, was returned to him as an invoice with the goods. The column for number shipped was filled by the warehouseman; on the extension strip it was filled by a checker at the loading platform.

Once a week the store manager forwards all reports, invoices, etc., to the main office. The envelope is opened and cash reports, payroll receipts, etc., are removed. All invoices, and receipts for cash payments, etc., are kept together. A code number for each vendor is written on each item in the envelope, including deliveries from the warehouse and cash paid out by the managers. It is a firm rule that all items that come in the envelope must be treated in the same manner and run through the accounts payable. This is to maintain uniformity in all items affecting store inventories. The envelopes are then processed by comptometer operators who check cost extensions and calculate retail values from the unit prices supplied by the managers.

The inventory ledger for each store is then posted in total by accounting machine for the total deliveries received from all sources. A tape of all invoices and delivery receipts for each store is created, showing store number, vendor number, retail value and cost. For deliveries from the warehouse, cost and retail are the same. At the same time a ticket is created for each invoice showing the same information. The total retail value is charged to each store and the cost accumulated as a control figure for accounts payable. At the end of the run, the tickets and tape are placed in the envelope for each store. Audit clerks then check the tape and invoices for correctness of prices and postings. After this check, the tickets created by the inventory posting are sorted by vendor numbers and the accounts payable vouchers posted in total for each vendor. A tape of the tickets for each vendor is made by the machine in the posting operation, showing store number and amount. These tapes are stored with the tickets until the vouchers have been reconciled with the vendors' statements. The tickets for deliveries from the warehouse are balanced with a total from the copies of the order sheets retained in the warehouse as a shipping record. Other inventory transactions not involving outside vendors, such as interstore transfers are similarly balanced.

The difference in price between the two types of stores is handled by using the price in service stores as a base price for credit to the warehouse. The warehouse order sheet for supermarkets shows both the selling price in that type of store and the base price in service stores. The retail value at both prices is totaled by the comptometer operators. At the inventory posting for the store, the supermarket price is used; later the price differential is run up and the warehouse given the additional credit. The price difference on items delivered directly to stores by vendors has no effect. Since the posting operation for the two types of store is run separately, all data is accumulated as though there were two separate chains.

Warehouse inventories are also controlled at retail value. When an invoice for merchandise is received, it follows a normal verification procedure, including price authorization, calculation and comparison with receiving records. The final step is the pricing and extension at retail value at the prices in service stores. The entry in the voucher register shows both retail and cost values.

Cost is credited to accounts payable and charged to markup. Retail value is charged to inventories and credited to markup. When goods are transferred to stores, the inventories are credited by the entry accumulated in the inventory posting and proven by the predetermined figure from the copies retained in the warehouse.

No attempt was made to maintain perpetual inventory records for the warehouse other than total dollar value. The method of operation of the client caused serious doubts as to the benefit to be gained. Insofar as purchasing controls are concerned, the fact that the buyers' office is in the warehouse, and that daily inspection of stock quantities are made, would require very fast presentation of balances to be useful. Trade practices, moreover, make a "normal" inventory balance impossible to compute in many instances because of seasonal goods, merchandising campaigns by suppliers, etc. For long range policy formulation, invoice analysis provides an adequate source of information.

Control of Cash in Stores

The second major step was the control of cash in the stores. Change funds are maintained in the stores, and receipts are sometimes deposited directly by managers, sometimes collected from stores and deposited in a central bank. It was found to be impractical to require deposit of all receipts and the maintenance of imprest funds. Large amounts of cash are required at times for check-cashing purposes. The funds could not be maintained at these high points all week. The managers are, therefore, allowed to retain as much cash as is usually required for the next day's business. Another factor to be considered was the frequency of differences between deposit slips and cash reports. A considerable amount of internal audit was required to follow up carryovers of daily cash balances and comparison of deposit tickets. To provide a check on these items, a clearing account was installed. All deposit tickets are entered in a cash receipts journal, with store deposits as a credit to the clearing account.

The managers' reports are on a cash basis with the exception of some few credit items, such as sales to relief recipients paid for by governmental vouchers, and coupons issued in advertising campaigns and redeemable in merchandise. Daily reports are prepared by store managers and are forwarded to the office weekly, except when physical inventory is taken by a roving inventory crew. In this event, the inventory crew picks up the daily reports to date and verifies the balance of cash on hand with the preceding day's report. A sales journal is posted weekly from the reports. The beginning cash balance plus sales, less expenditures, deposits and credit sales equals cash on hand at the end. If an inventory is taken during the week two postings are made, one to the date of the inventory and the other for the balance of the week. The grand totals of cash on hand beginning and ending are adjusted for the duplication in the stores covered by the inventory crew. The machine posting is provided with a proof column to throw out automatically arithmetical errors in the report of each store. This obviates proof of the report before posting. A double posting to the general ledger is made of all items except deposits. Cash on hand, sales, etc., are posted to the asset, income or expense account affected. A contra posting is made to the clearing account in the general ledger. These contra postings plus the cash receipts posting should equal zero or the store managers' reported deposits do not agree with amount received by the bank.

Amounts deducted for merchandise purchases are compared with the total in the accounts payable vouchering from inventory posting. Credit sales are covered by the accounts receivable control. Store inventories are then credited with the sales figure for each store. The grand total of inventory credits is compared with the sales journal total.

Meat Department Control

The meat departments in stores are considered separate units. Perpetual inventories were not feasible so supervision is accomplished by checking the percentage of gross profit weekly. For this purpose, each meat department takes an inventory every Saturday night. The mechanics of the accounting are very similar to the inventory posting for grocery departments, with the exception that purchases are charged at actual cost and the balance remaining after crediting sales and inventory is closed out to gross profit weekly.

Profit and Loss Determination

The final step in the installation was the preparation of a profit and loss account for each store. The actual cost of goods sold could not be determined because of lack of detailed inventories. Use of the gross markup on purchases was considered. The principal defect in this method is that purchase of high mark-up goods in a large amount in one week distorts results for that week because it is not known how much of these goods is left in inventory. The most glaring example is in the opening of a new store where the first week would show a profit of the markup of the entire inventory. The possibility that purchases were not always in direct proportion to sales was also noted. A series of tests were made of the gross profit ratio in various types of stores for periods varying from six to eight weeks. It was found that deviations from well established patterns were so minor after weighting for unusual purchases, etc., as to make application of a mark-up percentage determined for each of the several groups a more reliable index of success of operations than a gross profit determined from purchases adjusted for inventories.

The mark-up percentage is determined from the mark-up of items received in the warehouse, markup as shown by the inventory posting of items delivered to the stores, and goods provided by manufacturing divisions. All of these factors are weighted by proportion of total volume sold. The variations between stores are confined usually to comparative volumes in classifications such as dry groceries, produce, baked goods, etc., rather than gross profit for such classification. For example, if two stores each have a weekly volume of $20,000, the gross profit of each on dry groceries will be at the same rate. However, if in that volume one store sells $5,000 of produce and the other $1,000, gross profit will vary in the relationship of the gross profit on groceries and produce.

After determination of the current mark-up rate, a preliminary calculation is made monthly of the mark-up remaining in inventories. Deduction of this amount from mark-up added to invoice cost leaves the mark-up realized. A preliminary calculation of the mark-up rates by classes of stores should be compared with the general ledger control. The difference should be very small. The mark-up rates are then adjusted and applied to the store sales.

Expense classification for store profit and loss ledgers is small. Payroll, occupancy including utilities, supplies and miscellaneous are sufficient. Each store is charged with inventory shortage, spoilage, etc., as far as practical. The distribution of expense from the voucher register is accomplished by creating a distribution ticket at the same time that the voucher is posted. A ticket is created for each store affected where directly applicable and for each account in other cases. These tickets provide a very rapid analysis medium for general ledger posting or audit purposes.

All other records used were standard forms and will not be discussed here. A great many details of posting, form of journals, checks, etc. were carefully evolved but because they were governed to some extent by the policies and preferences of the client no further comment will be made.

After approximately two years of operation, the system appears to be giving satisfactory results.

New York State Tax Clinic

Conducted by BENJAMIN HARROW, C.P.A.

Taxability of Insurance Proceeds Under the Estate Tax Law

The Circuit Court of Appeals for the Second Circuit recently held[1] that a payment received by a widow after the death of a member of the New York Stock Exchange out of the "Gratuity Fund" of the Exchange was taxable in the decedent's estate as insurance proceeds. This decision reversed the Tax Court. The Gratuity Fund is part of a plan started by the Exchange in 1873 for the payment by surviving members of a sum of money, never more than $20,000, to the families of deceased members. Before anyone is elected to membership in the Exchange he must pay $15.00 into the Gratuity Fund, and he pays a like amount to the family of each deceased member. No member may select any beneficiary other than those provided for by the Exchange.

The Commissioner held that the payment to the widow was taxable as "proceeds of life insurance" under the Revenue Act of 1942. Under the present law all insurance proceeds are includible in the gross estate even if they are received by beneficiaries other than the estate on policies upon the life of the decedent where the decedent directly or indirectly paid the premiums or where the decedent at his death possessed any of the incidents of ownership in the policy. The Tax Court had held that the Gratuity Fund was not insurance.

The Court held that the payment was conditioned upon death and an analysis of the plan shows that in essence it is insurance as it was originally understood. The Tax Court had found that payment by members was not adjusted to age or health or any requirement as to a physical examination, or life expectancy. The Court of Appeals held that here, over the years and by a system of actual trial, the cost of the plan had been equated with the required contributions as successfully as more detailed analysis of the risks might have provided.

The Court held that in addition to finding that the plan was insurance, it must find that the insurance must result from contracts wherein the insured possessed at his death the incidents of ownership. The Court then refers to the Revenue Act of 1942 and the House Ways and Means Committee Report which cites examples of incidents of ownership. The usual examples are the right of an insured or his estate to the economic benefits of the insurance, the power to change the beneficiary, the power to surrender or cancel the policy, the power to assign the policy, the power to revoke an assignment, the power to pledge the policy for a loan,

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Mr. Harrow is engaged in practice as a certified public accountant and attorney in his own office in New York City.

1 *Commissioner* v. *Treganowon (Exrx., Estate of Max Strauss)* June 6, 1950.

the power to borrow against the surrender value of the policy.

Incidents of ownership are not limited to those possessed by a decedent in a technical legal sense. A power to put another in one's place as the insured is in the Court's opinion an incident of ownership. When a member of the Exchange sells his seat he divests his beneficiary of any right to payments, and the purchaser becomes entitled to whatever insurance the seller had. The payment of $20,000 to a deceased member's family is a right that goes with a seat on the Exchange and that right figures in the purchase price when a seat is sold.

The dissenting opinion of Judge Hand refers to the successive charges of $15.00 as being properly premiums, but he did not agree that a member had incidents of ownership in the insurance while he lived.

The case is particularly interesting in the contribution it makes to our modern concept of the testamentary character of insurance. The effect of decedent's death was to bring into being certain benefits to the beneficiary resulting from the decedent's membership in the New York Stock Exchange. The Court of Claims in 1939 said[2] that life insurance was "inherently testamentary in character. The payment of premiums and the insured's death are the necessary events giving rise to the full and complete possession and enjoyment of the face amount of the policies by the beneficiary. The acquisition of life insurance policies on one's own life is a substitute for a testamentary disposition of property . . . ."

Under the federal estate tax law there is no longer a $40,000 exemption of the proceeds of insurance payable to beneficiaries other than the estate. Under the New York estate tax law there is still an exemption of insurance proceeds to beneficiaries other than the estate. This exemption is equal to the amount of life insurance required to be included in the gross estate under Section 249-r but not in excess of $100,000 less the aggregate of any exemptions otherwise allowable under Section 249-q and also, in the case of insurance passing to a surviving spouse, less the amount of any deduction allowed by reason of the marital deduction provisions of the law. (Section 249-3)

Other Recent Estate Tax Decisions

Exemption for Widow — Computation: In *Estate of Henry Brower,*[3] the Surrogate of Nassau County held that a life estate in property given to a widow with a power to use such part of the principal as may be necessary for her support gives the widow an indefeasible interest in the whole estate, in effect a fee interest. The particular issue was whether an exemption of $20,000 would be allowed for the widow. Such a power to invade principal given to the widow is a power of appointment which would be taxable in the estate of the widow. In the husband's estate the property subject to the power would qualify for a marital deduction.

Deduction from Gross Estate: In *Estate of Harriette B. Maguire,*[4] the Surrogate of New York County held that debts, administration expenses and taxes are a charge against personal property and all real property of the decedent whether the real estate is within or without the state, except real estate specifically devised. Even real estate devised as part of the residuary estate would be subject to the payment of debts, administration expenses and taxes.

Apportionment of Taxes: Death taxes are generally apportioned against all property constituting the gross estate, including *inter vivos* trusts that are part of the taxable estate. However, this rule is subject to contrary directions to executors in a will. In *Estate*

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[2] *Bailey* v. *United States,* 27 F. Supp. 617.
[3] May 3, 1950.
[4] New York Law Journal, August 1, 1950, page 167; ibid., August 10, 1950, page 223.

of Eugene Higgins[5] a New York Surrogate held that if the will directs payment of death taxes out of "my general estate . . . or upon the property or legacies or annuities given by this my will . . ." *inter vivos* trusts would not be charged with a proportionate share of such taxes. It is important for decedents to be aware of the effect of the apportionment provision in the law and in their wills.

Determination of Net Income: Where real estate is held in trust with income going to a life tenant, no depreciation will be charged against the income unless there is an express direction in the trust instrument that the trustor so intended. That is the decision in *Matter of Ernest Flagg, Dec'd.*[6]

Right of Election Under Section 18, Decedent Estate Law

A will provided for a division of the residuary estate in fixed proportions. One share was to be held in trust for the benefit of the widow for life or until her remarriage. On the happening of either event the remainder was to go to two named children. The widow claimed a right of election to take her one-third intestate share of the net estate against the will. The Surrogate held[7] that the widow had an absolute right of election since the trust provisions for the widow were restricted until her remarriage. In addition to the one-third share, the widow is entitled to interest on her share at the rate earned on the general estate during administration. Because of the election of the widow and the apparent intention of the testator in the provision he made for the widow and the children, the Surrogate was of the opinion that the balance of the trust principal could be presently distributed. The Surrogate therefore held that, after deducting the contribution toward the widow's intestate share, the remainder was presently payable to the testator's children. In apportioning the death taxes the widow would of course bear her proportionate share of her one-third interest.

Unemployment Insurance—Allocation of Bonuses to Establish Contribution Credits

Several years ago, the law provided for merit ratings for qualified employers, which were applied as a credit against contributions for a current year. For two years employers received such a credit. No credit was authorized for the current year 1950 to 1951 because the surplus in the Unemployment Insurance Fund had dropped below the amount provided for in the law. However, it is likely that the credit will be restored in the next fiscal year.

Employers generally are not fully aware of the factors that enter into the determination of their credit ratings, nor how they can raise the amount of the credit merely by requesting that bonuses or lump sum payments made during any calendar year be apportioned for the year. One of the factors used in determining the credit rating is the extent to which there have been quarterly decreases in remuneration covering a period of three consecutive calendar years. The greater the percentage of decrease the lower the quarterly factor, with a consequent reduction in the final computation of the credit rating. If a bonus is paid to employees in the fourth quarter of a year, the total remuneration for that quarter will probably be much greater than the total remuneration for the following quarter. Essentially, this does not mean that there has been a reduction in the level of employment, which it is the purpose of the law to reward. Actually, the remuneration for one quarter has been increased because of the bonuses intended to cover compensation for four quarters. The law recogizes that fact by providing that

[5] New York Law Journal, July 13, 1950, page 59.
[6] Surrogate's Court, Richmond Co., N. Y. L. J., July 24, 1950, page 121.
[7] *Matter of Emanuel Giddings, Dec'd.*, Kings County, N. Y. L. J., July 11, 1950, page 46.

bonuses and lump sum payments for services performed over a period of more than three months may be apportioned equally among the four calendar quarters of the year for the purpose of computing quarterly decrease quotients.

Regulations under Article 18 (Section 577 (1) (h) (2) of the New York State Labor Law) require an employer to make a request in writing for such an apportionment of remuneration with the Division of Placement and Unemployment Insurance on or before September 30th following the year during which such bonuses were paid. The request must include a statement of all lump sum remuneration paid in each calendar quarter of the year.

Unemployment Insurance—Interstate Transfer of Experience

Subdivision 8 of Section 577 was added to the law in 1948 (effective March 21, 1948) and provides that an employer who transfers all or a divisible part of his business from another state to New York may be considered a "qualified employer" under the New York law if he complies with certain conditions:

a. He must have paid wages subject to the federal unemployment tax act (excise tax on eight or more employees) for seventeen consecutive calendar quarters.

b. He must notify the Commissioner of the transfer of operations prior to the first computation date following the transfer of operations.

The Regulations require the employer to furnish a statement of the wages paid prior to the transfer of the business to each employee engaged in the transferred operations for each calendar quarter for the current calendar year and the four preceding calendar years. Also required is a statement of the names and social security numbers of all transferred employees who, during each of the last three benefit years, were paid benefits for four or more weeks by the former state.

The Division of Placement and Unemployment Insurance furnishes forms and instructions for the above information.

National Tax Association—Annual Conference

The 43rd Annual Conference on Taxation was held in Pittsburgh, Pa., and lasted from September 11th to the 14th. The Conference was devoted to an appraisal of government fiscal problems at federal, state and local levels. The shadow of the war emergency blanketed the proceedings. There was complete unanimity of opinion that more money will have to be spent for military purposes. Roswell Magill was the first speaker and he analyzed "Our Fiscal Resources for the Emergency." Surprisingly, he saw no immediate fiscal emergency. For that reason while he would agree that the excess profits tax must be reinstated, he would probably defer it until 1951. In discussing the excess profits tax he posed such questions as what are fair profits for different industries? How much over 45% should the government get? How devise a fair base? We have not yet found a satisfactory way to determine abnormal profits, he thinks. Perhaps abnormal profits should be reached through renegotiation rather than taxation. Magill emphasized the need for control of non-essential civilian expenditures. This idea also ran through most of the talks. Senator Byrd, of Virginia, who delivered the principal address at the Conference banquet stated that this was one of the principal problems facing us at home. To meet our emergency needs Magill thought that personal exemptions must be lower and tax rates higher. He also stated that the design of heavy taxes will be with us for the rest of our lives. He was troubled that the effect of high taxes would be unduly to discourage the incentives for "making money."

Leon Keyserling, who also spoke at the first general session, was a bit on the optimistic side. Our economic

potential is so tremendous that the national income can be raised to unprecedented heights. This is the fact in our capitalist economy that the Russians fear most.

Many of the speakers were worried over the national debt now at a high of 258 billion. Of the 320 billions that World War II cost us, only 150 billions were raised by taxes. It was hoped that the Korean War could be financed entirely by taxes.

Report of the Committee on the Federal Corporate Net Income Tax

The Chairman of this committee is Professor Harold M. Groves of the University of Wisconsin and a summary of his report was read at the second general session. Because of present demands upon governmental revenue no tax relief which would decrease this revenue was considered. The committee reported that undistributed profits in 1949 dropped from 61% to 51%. It was the opinion of the committee that the incidence of the corporate tax is primarily upon the stockholder. The higher the tax the lower the return to the stockholder. It is the common conception that the tax is shifted to the consumer or to labor. For the short period and to a minor extent only this may be true.

Most of the report is concerned with the problem of double taxation. Under our present tax system the retention of corporate earnings is favored, and this results in tax avoidance and a concentration of wealth in American industry through retained earnings with a resulting hoarding and mis-investment. The committee concludes that it would not be feasible to tax all stockholders on their prorata shares of retained earnings, as partnership income is taxed, although this would be the ideal solution. The committee would apply the partnership treatment to small and closely held corporations. It recognizes the difficulties involved and therefore thinks it unwise to make any definite recommendation on the matter. The committee considered proposals for taxing accumulated surplus and capital gains to the stockholder. Under these suggestions capital gains would be deemed to be "constructively realized" by death and gift transfers. Another feature suggested was the taxation of accumulated surplus at a low rate equivalent to an interest charge on taxes forborne by the government. With these suggestions would be the elimination of the corporate tax as such.

The major recommendation was made in connection with a dividend credit. Three possibilities were considered, a dividend paid credit, a dividend received credit, and a plan of withholding. Under the dividends paid credit plan the corporate income tax would be retained but corporations would be allowed a deduction or credit for dividends paid, similar to the deduction for interest. Under the withholding plan a tax would be collected from the corporation when profits were earned. This would be regarded as a withholding against the tax of stockholders when dividends were distributed. The stockholder would consider as taxable income actual dividends received plus the withholding tax on such dividends, but would receive a credit for the withholding tax. If the withholding exceeded the stockholder's tax liability, he would receive a refund. Under the dividend received credit method the dividend would be exempt from a part of the individual tax rates.

The committee feels that the dividend paid credit and the withholding plan provide for a full integration of corporate and personal taxes. The dividend received credit does not call for refunds where a stockholder's tax liability is less than the credit. This plan, the committee thinks, favors the high income stockholder. Says the committee, "there is little to be said for it except that it is administratively simple." Also, "None of our members except one had any kind words for the dividend received credit." The committee supports the dividend paid credit approach as

easier to administer and as encouraging larger distributions, although a considerable group preferred the withholding method.

The committee also made a specific proposal that the corporate tax rate be raised to 45 per cent on retained earnings and 30% on dividends paid out of earnings. For corporations with incomes of about $250,000 (small corporations) the rate would be 30% on one-half the income and 45 per cent on the balance. This proposal incorporates the idea of a partial credit for dividends. About ten pages of the report are devoted to a discussion of this proposal. The study of the committee was made before the Korean War and probably the recommendations will have to be deferred until the war is ended.

The Conference included a round table on the Personal Property Tax, Capital Gains and Losses, Integration of Payroll and Withheld Income Taxes, Uniform Administration of the Sales and Use Taxes. There were general sessions on the Problems of Expenditure and Debt Control, Coordination of Federal, State, and Local Taxes, and an Interim Report of a Committee on Tax Situs and Allocation. The Conference was well worth attending. It is the only organization on a national level that offers a meeting ground for the tax administrators of the country, the academic specialists in the field of taxation, and tax-minded business men.

The Taxation of Partnership Income

The partnership as such is not a taxable entity for income tax purposes, although it is treated as a taxable entity under the unincorporated business tax. It is the individual partners that are taxed and the tax is computed on the distributive shares of the partners from the partnership whether actually distributed or not and regardless of whether the individual partners are otherwise reporting on a cash or accrual basis.

The partnership as such is treated as an entity for some purposes. It may have its own taxable period which may be different from the taxable period of the partners. It may report its income on its own basis, cash or accrual, and this may be different from the basis upon which the individual partners are reporting.

Suppose a partnership is reporting on a fiscal year basis ending March 31. Suppose further that the partnership dissolves on November 30, at which time it transfers all of its assets to a corporation organized by the individual partners. Are the individual partners taxable on their distributive shares of the income of the partnership for the period from April 1, 1949, to November 30, 1949, for 1949 or for 1950, the year in which the fiscal year of the partnership would normally end?

The final return of a partnership may be for a fiscal year different from the regular fiscal period of twelve months. This is so for the reason that the final tax period cannot extend beyond the period of the existence of the partnership. This period would have to be from the beginning of the fiscal year to the last day of the life of the partnership. The effect of this rule on the individual partners may be to bunch the income of more than twelve months in one year. By the same token if the partnership sustained a net loss in the final period, the individual partners could offset their distributive share of the loss against any net income for the prior partnership year if both dates happened to fall in one year, as in the instant case. We know of no case where the Tax Commission has permitted or required a partnership to report upon the basis of its normal fiscal period if it ceased to exist before the end of the period.

Accounting at the S. E. C.

Conducted by Louis H. Rappaport, C.P.A.

In December, 1947, the Institute's Committee on Accounting Procedure issued a bulletin (No. 32) on the subject of income and earned surplus. This is the bulletin in which the committee stated its opinion that all profit and loss items recognized during the period are to be used in determining the figure reported as net income, the only exception being with respect to items which in the aggregate are materially significant in relation to the company's net income and which are clearly not identifiable with or do not result from the usual or typical business operations of the period. Thus, in the committee's opinion, only certain extraordinary items may be excluded from the determination of net income, and they should be excluded when their inclusion would impair the significance of net income so that misleading inferences might be drawn therefrom.

The SEC was not in agreement with Bulletin No. 32, and, shortly after it was issued, the Chief Accountant of the SEC, Earle C. King, made clear the position of the Commission in a letter to Carman G. Blough, the Institute's Director of Research. At Mr. King's suggestion the letter was reprinted in The Journal of Accountancy for January, 1948. In his letter Mr. King said the procedures recommended in the bulletin "seem to be susceptible to abuse and may result in misleading income and earned surplus statements." The SEC has authorized the staff to take exception to financial statements which appear to be misleading, even though they reflect the application of the bulletin.

More than two years have passed since the SEC stated its position, and it may be interesting to see how the bulletin has fared at the hands of the Commission. The following cases are taken from actual filings with the SEC, but I am withholding the names of the companies involved and their accountants because I do not wish to give even the appearance of being critical of either.

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Case No. 1: Loss on sale of fixed assets

In March, 1950, a prospectus was issued by Company A. The significant portion of the company's income statement for the year ended July 2, 1949, was as follows:

Income before taxes on income and loss on disposal of mill properties	x x x
Provision for taxes on income ..	x x x
	x x x
Special charge equivalent to estimated reduction of taxes on income due to sale of milling properties, offset against loss thereon charged below.......	$230,000
Net income before loss on disposal of mill properties......	558,005
Net loss on disposal of milling properties, less estimated reduction of taxes on income, $230,000	374,855
Net income	$183,150

One of the notes to the financial statements dealt with the loss on sale of milling properties. The note follows:

Under the terms of a contract dated May 28, 1949, the parent company sold

its mill properties and discontinued its milling operations as of June 13, 1949. In its consolidated financial statements for the year ended July 2, 1949, accompanying the annual report for that year to the stockholders, the company charged to consolidated earned surplus the loss directly attributable to this sale, $604,855, less estimated applicable reduction in Federal income taxes of $230,000, a net amount of $374,855. The company believes that its treatment of this item was proper. However, in compliance with the request of the Securities and Exchange Commission, the company is now reflecting this loss as a charge to consolidated income for the year ended July 2, 1949.

The accountants' certificate applicable to this statement read, in part, as follows:

> It is our opinion that the loss on the sale of the parent company's mill properties, explained in Note "I" of the notes to consolidated financial statements, should be charged to consolidated surplus rather than to consolidated income for the year ended July 2, 1949.
>
> In our opinion, with the explanation indicated in the preceding paragraph, such financial statements present fairly . . . consolidated financial position . . . and results of operations . . . conformity with generally accepted accounting principles applied on a consistent basis.

Case No. 2: Loss on devaluation of foreign currency

An annual report on Form 10-K was filed by The B Corporation for its fiscal year ended September 30, 1949. In the financial statements, an unrealized exchange loss of $223,000 on conversion of net assets of Canadian subsidiaries resulting from devaluation of the Canadian dollar was charged to earned surplus. The net income for the year shown by the income statement was $1,224,000. At the request of the SEC the financial statements were subsequently amended to include the unrealized exchange loss in income. In the amended income statement the amount of $1,224,000 is captioned "net operating profit for the year", and from this amount is deducted the unrealized exchange loss resulting in "net income for the year transferred to earned surplus" of $1,001,000.

The amended certificate of the certifying accountants covering the amended statements begins with the usual opening paragraph and continues as follows:

> In the attached amended consolidated statements of profit and loss and earned surplus, the unrealized exchange loss of $223,000 on conversion of net assets of Canadian subsidiaries is treated as a charge to income in conformity with a suggestion from the Securities and Exchange Commission, whereas in the annual report to stockholders this item was shown as a charge to surplus. Although either method may be regarded as acceptable, we believe that it would be preferable to carry this charge direct to surplus account because (1) the loss was occasioned by governmental devaluation of currency which should not be regarded as a recurrent or normal business hazard, and (2) the amount of such loss is large in relation to the net operating profit.
>
> In our opinion, with the foregoing explanation . . . financial statements present fairly . . . (balance same as original).

AN ADIRONDACK VIEW

We Give Thanks, with humility, for a lot of things, that have come to us, without the need of special action on our part. For example—we give thanks for the Arabs. They had a better system of numbers than the highly touted Roman's system. And, even though they lived in the desert, instead of the middle of the woods, a path was beaten to their door and the Arabic numerals were brought out for us to use. Imagine using XXXVIII just to write 38!

We give thanks to the American colonists who discovered the turkey and invented a day upon which to eat it. They also threw overboard the English system of money—along with the tea, probably. What a good heave that was. If we had to do accounting in pounds and pence, none of us would have time to do any Boy Scout work or help in the Community Chest campaign.

And we are thankful for the coming of winter. Now we can't play golf, go boating, etc.—perhaps we can get some work done.

LEONARD HOUGHTON, C.P.A.
of the Adirondack "Chapter"

A Note on Two Recent New York State Unemployment Insurance Decisions

By SAMUEL S. RESS

Service Agency Held Not Liable for Unemployment Insurance Contributions on Claimant's Earnings

During busy periods, or to do a special job, some employers call upon a special service office for help, rather than hire the required personnel directly. They pay the service agency an agreed amount to have the job done. Some rate arrangements are on a manhour or a per diem basis. This practice is followed frequently in connection with preparation of special reports such as the year-end individual Federal Withholding Tax W-2 reports and various State individual employee information returns.

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Dr. Ress, who has written a number of articles which have appeared in *The New York Certified Public Accountant*, is a member of the Society's Committees on Clothing Manufacturing Accounting and on Labor and Management.

Some of the reasons for using this device are to reduce labor turnover, to save on labor personnel records, and to save on workmen's compensation premiums or State Unemployment Insurance and Federal Social Security Taxes.

The New York State Unemployment Insurance Appeal Board in Case #23,700-50, decision dated September 11, 1950, has held that the service agency that provides the personnel is not the employer required to pay the State unemployment contributions on the earnings of such personnel, even though the service agency paid the wages to the personnel out of fees collected from their clients. However, the Appeal Board indicated in its opinion that the clients of the service agency would have to pay for the unemployment insurance contributions due on the earnings of the persons who performed the services if the clients were covered by the New York State Unemployment Insurance law.

The factual situation in this case is of particular interest to accountants who from time to time are faced with special jobs that require the use of a large number of clerical workers.

The case at bar arose when a claim for unemployment insurance benefits was filed. The appellants in the case were the principals of the service agency that provided the personnel. They disputed their liability. The facts in the case before the Appeal Board were:

Appellants, during the periods involved, were engaged in the business of placing office help, such as public stenographers, typists, bookkeepers and kindred clerical employees, on a tem-

porary hourly basis with persons and firms requesting such type of service.

The claimants involved—a typist, a stenographer and a comptometer operator—were among many persons placed by appellants in employment, as aforesaid. At no time did they perform any services for appellants at any fixed time. Appellants did not exercise any supervision or control over their activities. The claimants were not required to report at appellants' establishment but were contacted by phone when there was any need of their services. They were free to reject or accept the assignments offered by appellants. Claimants' remuneration was fixed at an hourly rate and paid by the persons or firms requiring their temporary service to the appellants, from which sums appellants deducted a stipulated fee for recommending their services.

At various times claimants filed applications for unemployment insurance benefits. They were ruled ineligible because their earnings with appellants in the base year 1948 were held not to be in covered employment.

The claimants contested the respective initial determinations which culminated in a decision rendered by a referee holding that their relationship with appellants was that of employer-employee. From this decision the appellants now appeal to this Board. The Appeal Board decided as follows:

"After an analysis of the testimony in this case, we hold that the claimants were not employees of appellants. The said claimants were not subject to any supervision or control by appellants. They were not required to devote any fixed time in the service of appellants. Moreover, in rendering their services, they did not do so pursuant to a contract of hire with appellants. Appellants merely referred them to employment with other persons and firms on a temporary or part-time basis.

"It therefore follows that appellants were not required to pay contributions based upon the earnings of claimants. Claimants may be entitled to be credited with their respective earnings while in the employ of the clients of appellant. Since there is no evidence before us upon this issue, this case is returned to the respective local offices for further inquiry and new initial determinations as to eligibility for benefits of these claimants based on their earnings with the clients of appellant.

"The initial determinations of the local offices holding that the claimants had insufficient earnings in the base year 1948 to qualify them for benefits are sustained, subject to review by the respective local offices in accordance with the above opinion."

If you or your clients make use of a special service agency, be sure to ascertain whether or not the service agency has been reporting and paying unemployment insurance, social security and withholding taxes on the earnings of the personnel involved. Under the terms of this decision you or your client may be saddled with a large additional tax liability plus penalty and interest assessments if the earnings were not reported and contributions were not paid by the service agency, as occurred in the reported case.

Proper Period for Reporting Seamen's Wages in Maritime Industry

Another decision of great importance to the shipping industry involves the method of reporting the wages and other allowances for seamen.

The appeal in case #23,254-50, decision dated September 11, 1950, also arose out of an unemployment insurance benefit claim which had been denied. The Appeal Board found:

"The referee sustained the contention of the Industrial Commissioner that the employer had properly allocated claimant's earnings. We do not agree with this conclusion. Regulation 29 of the Industrial Commissioner as amended on March 24, 1949, effective February 1, 1949, provides as follows:

" 'a. For the purpose of this regulation, the term "pay period established by shipping articles" means the period of a voyage or engagement of the crew of a vessel under "Articles of Agreement" pursuant to title 46 of the United States Code. This regulation shall not apply to wages payable on fixed pay days for regularly recurrent payroll periods which are not longer than one month.'

" 'b. Notwithstanding any other provision of regulations 2, 22 and 23, contributions and wage reports with respect to wages,

(Continued on page 695)

OFFICIAL DECISIONS *and* RELEASES

REVISIONS OF THE REGULATIONS OF THE COMMISSIONER OF EDUCATION GOVERNING HIGHER AND PROFESSIONAL EDUCATION

Article XI

Certified Public Accountancy

§ 90 Preliminary requirement

The preliminary education requirement for admission to a registered course of study in a college or school of accountancy shall be the satisfactory completion of a four-year secondary school course of study approved for this purpose, or the equivalent as determined by the Commissioner of Education.

§ 91 Professional requirements

1 Candidates for the certified public accountant certificate who have completed their course of study in a college or school of accountancy registered by the Department as maintaining a satisfactory standard, or its equivalent as determined by the Commissioner, shall be entitled to admission to the examination in theory of accounts (,) *and* in commercial law (and in auditing).

2 Candidates who complete three years of diversified accounting experience satisfactory to the State Board of Certified Public Accounting Examiners, subject to review by the Commissioner of Education, shall be entitled to admission to the examination in *auditing and in* practical accounting. Diversified accounting experience to be considered satisfactory shall be such as to have required the intensive application of accounting principles and auditing procedures *in the public practice of accountancy.*

3 Upon passing the above examinations and meeting all other requirements established by law and the regulations of the Commissioner, the candidate will be entitled to the certified public accountant certificate.

§ 92 Other requirements

1 The certified public accountant examinations shall be held at such times and places as shall be determined by the Commissioner.

2 A candidate for admission to the certified public accountant examination must show to the satisfaction of the Commissioner of Education that:

a He is a citizen of the United States or has declared his intention of becoming such citizen.

b He resides in or has a place for the regular transaction of business in the State of New York.

c He is of good moral character.

3 Each application must be accompanied by a recent photograph approximately two by three inches in size and by a fee of $25, which fee shall entitle the candidate to two complete examinations. Examinations in two or more subjects are considered a "complete" examination. No fee is required of a candidate who is scheduled by the Department for a single subject only. A candidate who passes two subjects in any one examination shall not be re-examined in such subjects. However, a candidate who passes the subject of practical accounting *or auditing* shall not be re-examined in that subject. *Any candidate who has failed any subject in four successive examinations shall not be eligible for admission to any subject in the two succeeding examinations.*

4 The passing mark in each subject shall be 75 per cent.

5 An application for admission to the examination in theory of accounts (,) *and* in commercial law (and in auditing) shall be filed with the Department not less than 30 days prior to the date of the examination; an application for admission to the examination in practical accounting *or in auditing* shall be filed with the Department not less than 90 days prior to the date of the examination. Any false or misleading information in connection with any application may be cause for exclusion from the examinations on the ground of lack of good moral character. If the Department finds that the application is complete and that all of the requirements (of the statute and of the regulations) have been met, it shall issue to the applicant an admission card which shall advise him of the time, date and place of the examination. When the candidate submits each examination paper he shall exhibit his admission card to the examiner. At the conclusion of the final examination the examiner shall retain the card.

New matter added is *italicized.* Old matter eliminated is (bracketed).

6 Licensing examinations shall be conducted in accordance with the following procedure, and any candidate violating such procedure may be dismissed from the examination room or otherwise disciplined.

a No candidate shall enter the examination more than 45 minutes after the question papers have been distribued nor shall any candidate leave the examination until 45 minutes have elapsed.

b During the examination no candidate shall communicate with any other candidate in any way.

c A candidate shall not bring books or other help of any kind into the examination room unless directed to do so by the Department because of the character of the examination.

d After handing in his last paper in any examination each candidate shall make and subscribe to a statement to the effect that he has neither given nor received aid during the examination.

A Note on Two Recent New York State Unemployment Insurance Decisions

(Continued from page 693)

including advances, allotments, and payment in kind, such as board and lodging, paid in any pay period established by shipping articles shall be submitted as of the calendar quarter in which any such wages in cash were actually paid or such wages in kind were furnished.' "

"In allocating claimant's wages to the first quarter of 1949, when they were actually paid, the employer was acting in accordance with Regulation 29 as it now reads.

"However, prior to such amendment, Regulation 29 (2) (b) read as follows:

> (b) If wages were earned for a pay period established by shipping articles which includes more than one calendar quarter, they shall be prorated among such calendar quarters according to the length of employment in each of such quarters. Reports on such wages, accompanied by payment of contributions, shall be submitted on or before that date on which under the general provisions of this regulation reports are due on wages paid in the calendar quarter in which such pay period terminates. Separate reports shall be submitted as to wages earned in each of such quarters.

"Thus, prior to the amendment, the wages paid to a seaman employed pursuant to shipping articles, were allocated to the various quarters during which they were earned, even though they were not actually paid to him until a later date.

"In applying for benefits based upon his 1948 earnings, claimant is entitled to have his earnings computed according to the law and regulations in effect at the close of that year. Had the employer filed its report on the date on which it was due under the regulation then in effect, claimant would have been credited with that portion of his entire wages, which had accrued during the fourth quarter of the base year 1948.

"According to a written communication submitted to the Board by the employer, claimant would be credited with the following:

In port—October 28, 1948-November 1, 1948

Wages	$ 44.61
Board & Lodging	5.50
Overtime	32.52
	$ 82.63

On voyage—November 2, 1948-December 31, 1948

Board & Lodging	$ 72.00
Advances	104.75
Slops	26.38
Allotment	150.00
Wages	255.33
Overtime	276.00
	$884.46

"This makes a total of $967.09 for the fourth quarter of 1948. Claimant is therefore eligible for maximum benefits."

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